

**NEW ISSUES AND REMARKETING****BOOK ENTRY ONLY**

The Honorable Daniel E. Lungren, then-Attorney General of the State of California, and Hawkins, Delafield & Wood ("Bond Counsel") delivered opinions in connection with the issuance of the 1997 Series C Bonds, dated such date of issuance. Each such opinion states that, based on then-existing statutes and court decisions and assuming compliance by the Department with certain tax covenants described herein, the interest on the 1997 Series C Bonds (i) was not included in gross income for federal income tax purposes under then-existing statutes and court decisions, (ii) would be treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Internal Revenue Code of 1986, as amended (the "Federal Tax Code"), with respect to individuals and corporation, and (iii) was exempt from personal income taxes of the State of California under then-current State law. It is a condition to the remarketing of the 1997 Series C Bonds that The Honorable Bill Lockyer, Attorney General of the State of California (the "Attorney General"), and Bond Counsel deliver opinions on the remarketing date of the 1997 Series C Bonds that not converting the interest rate on such bonds on such date to fixed interest rates will not, in and of itself, adversely affect the exclusion of interest on the 1997 Series C Bonds from gross income for federal income tax purposes.

In the opinion of the Attorney General and Bond Counsel, assuming compliance by the Department with certain tax covenants described herein, the interest on the 1999 Series A Bonds and 1999 Series B Bonds is not included in gross income for federal income tax purposes under existing statutes and court decisions and the interest on the 1999 Series A Bonds and 1999 Series B Bonds is exempt from personal income taxes of the State of California under present State law. The Attorney General and Bond Counsel are of the opinion that the interest on the 1999 Series A Bonds and 1999 Series B Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Federal Tax Code with respect to individuals and corporations; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations. See "TAX MATTERS" herein.

**\$240,255,000****Department of Veterans Affairs of the State of California  
Home Purchase Revenue Bonds****New Issues****\$54,170,000 1999 Series A (Non-AMT)  
\$86,085,000 1999 Series B (Non-AMT)****Remarketing****\$100,000,000 1997 Series C (AMT)****Dated: As shown on inside front cover page****Due or Subject to Mandatory Tender: As shown on inside front cover page**

The 1997 Series C Bonds, the 1999 Series A Bonds and the 1999 Series B Bonds referred to above (collectively, the "Offered Revenue Bonds") will be issued as fully-registered bonds in denominations of \$5,000 or any integral multiple thereof in book-entry form.

Interest on the 1999 Series A Bonds and the 1999 Series B Bonds is payable on June 1 and December 1 of each year, commencing June 1, 1999. The 1999 Series A Bonds and the 1999 Series B Bonds are subject to redemption prior to maturity, including redemption at par, as described herein.

Upon remarketing, each 1997 Series C Bond will bear interest, payable on June 1 and December 1 of each year, commencing June 1, 1999, and on the applicable Mandatory Tender Date, from its remarketing date at the rate and will be subject to mandatory tender on the applicable Mandatory Tender Date, as shown on the inside front cover page. **This Official Statement is not intended to provide any information with respect to any 1997 Series C Bond after its applicable Mandatory Tender Date.** The 1997 Series C Bonds are subject to redemption at par, in whole or in part, on the applicable Mandatory Tender Date or on any date that could be designated as the Mandatory Tender Date, as described herein.

**MATURITIES, MANDATORY TENDER DATES, PRINCIPAL AMOUNTS, INTEREST RATES  
AND PRICES OR YIELDS  
(as shown on inside front cover page)**

The Offered Revenue Bonds are special obligations of the Department payable solely from, and equally and ratably secured with other Revenue Bonds by a pledge of, (i) an undivided interest in the assets of the Veterans' Farm and Home Building Fund of 1943 (the "1943 Fund") (other than proceeds of Veterans G.O. Bonds, as defined herein, and amounts in any Rebate Account), (ii) the Bond Reserve Account, and (iii) the Loan Loss Account. The undivided interest in the assets of the 1943 Fund is secondary and subordinate to any interest or right in the 1943 Fund of the people of the State of California and of the holders of Veterans G.O. Bonds under any general obligation veterans bond act. The Department has no taxing power. Neither the faith and credit nor the taxing power of the State of California or any political subdivision thereof is pledged to the payment of the principal of or the interest on the Offered Revenue Bonds.

This cover page contains certain information for quick reference only. It is *not* a summary of this issue. Investors must read the entire Official Statement to obtain information essential to the making of an informed investment decision.

The 1997 Series C Bonds are being remarketed by the Underwriters set forth below subject to certain conditions, including receipt of the opinion of The Honorable Bill Lockyer, Attorney General of the State of California and Hawkins, Delafield & Wood, Bond Counsel, described above. The 1999 Series A Bonds and 1999 Series B Bonds are offered when, as and if issued and delivered to the Underwriters and are subject to the approval of legality by The Honorable Bill Lockyer, Attorney General of the State of California, and by Hawkins, Delafield & Wood, Bond Counsel. Certain legal matters will be passed upon for the Underwriters by their counsel, Kutak Rock. Public Resources Advisory Group has served as Financial Advisor in connection with this transaction. It is expected that the Offered Revenue Bonds in book-entry form will be available for delivery at the offices of The Depository Trust Company on or about March 30, 1999 for the 1999 Series A Bonds and 1997 Series C Bonds, and on or about May 4, 1999 for the 1999 Series B Bonds.

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**Honorable Philip Angelides  
Treasurer of the State of California**

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**Merrill Lynch & Co.****Bear, Stearns & Co. Inc.  
J.P. Morgan & Co.****Great Pacific Securities Inc.  
NationsBanc Montgomery Securities LLC****Ramirez & Co., Inc.**

March 17, 1999

## **MATURITY SCHEDULE**

### ***NEW ISSUES***

**\$54,170,000 1999 SERIES A BONDS (Non-AMT)**

**Dated: March 1, 1999**

**Delivery Date: March 30, 1999**

**\$8,690,000 5.10% 1999 Series A Term Bonds due December 1, 2019 @ 100%**

**CUSIP No. 130658GN1**

**\$45,480,000 5.20% 1999 Series A Term Bonds due December 1, 2027 @ 99.625%**

**CUSIP No. 130658GP6**

**(plus accrued interest)**

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**\$86,085,000 1999 SERIES B BONDS (Non-AMT)**

**Dated: March 1, 1999**

**Delivery Date: May 4, 1999**

**\$12,840,000 5.10% 1999 Series B Term Bonds due December 1, 2019 @ 100%**

**CUSIP No. 130658GQ4**

**\$73,245,000 5.20% 1999 Series B Term Bonds due December 1, 2028 @ 99.625%**

**CUSIP No. 130658GR2**

**(plus accrued interest)**

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### ***REMARKETING***

**\$100,000,000 1997 SERIES C BONDS (AMT)**

**Interest to Accrue from Remarketing Date of March 30, 1999**

**Dated: December 29, 1997**

**Delivery Date: March 30, 1999**

**1997 Series C Term Bonds due December 1, 2019 @ 100% CUSIP No. 130658GE1**

3.65%, with respect to each 1997 Series C Bond, to and including the day preceding its Mandatory Tender Date. All or any portion of the 1997 Series C Bonds is subject to mandatory tender (with no right to retain) on a Mandatory Tender Date. The Mandatory Tender Date for any 1997 Series C Bond is December 1, 2001, unless the Department designates one or more business days prior thereto on or after August 1, 2000 as the Mandatory Tender Date for all or any portion of the 1997 Series C Bonds. Individual 1997 Series C Bonds may have different Mandatory Tender Dates.

# **STATE OF CALIFORNIA**

Gray Davis, *Governor*

## **DEPARTMENT OF VETERANS AFFAIRS**

James R. Ramos  
*Secretary*

Bruce Thiesen  
*Deputy Secretary, Operations*

Sheryl A. Schmidt  
*Deputy Secretary, Women Veterans Affairs*

Kandis L. Mendonsa  
*Chief, Bond Finance Division*

Tomas Alvarado  
*Undersecretary*

Curtis Howard  
*Deputy Secretary, Administration*

Mike Madalo  
*Chief, Farm and Home Purchases Division*

## **VETERANS' DEBENTURE FINANCE COMMITTEE**

Gray Davis, *Governor*

Philip Angelides  
*State Treasurer*

Tim Gage  
*Director of Finance*

Kathleen Connell  
*State Controller*

James R. Ramos  
*Secretary of Veterans Affairs*

## **CALIFORNIA VETERANS BOARD**

Bennett S. Sparks, *Chairman*

Robert D. Dolman

Leo P. Burke

James R. Ramos

## **CALIFORNIA STATE TREASURER'S OFFICE**

Philip Angelides, *State Treasurer*  
(as *Trustee* and as *Agent for Sale*)

## **ATTORNEY GENERAL OF THE STATE OF CALIFORNIA**

Bill Lockyer, *Attorney General*

Steve Coony, *Chief Deputy Attorney General for Administration and Policy*

Peter Siggins, *Chief Deputy Attorney General for Legal Affairs*

## **BOND COUNSEL**

Hawkins, Delafield & Wood

## **QUANTITATIVE CONSULTANT**

cfX Incorporated

## **FINANCIAL ADVISOR**

Public Resources Advisory Group

## **INDEPENDENT AUDITOR**

Deloitte & Touche LLP

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*No dealer, broker, salesman or other person has been authorized by the Department of Veterans Affairs or the Underwriters to give any information or to make any representations with respect to the Department of Veterans Affairs or its Offered Revenue Bonds other than those contained in this Official Statement and, if given or made, such other information or representations must not be relied upon as having been authorized by any of the foregoing. The information set forth herein has been obtained from sources which are believed to be current and reliable. Estimates and opinions are included and should not be interpreted as statements of fact. Summaries of documents do not purport to be complete statements of their provisions and such summaries are qualified by references to the entire contents of the documents. The information and expressions of opinion herein are subject to change without notice, and neither the delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Department of Veterans Affairs since the date hereof.*

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**IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY OVERALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE OFFERED REVENUE BONDS AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.**

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**Official Statement  
of  
Department of Veterans Affairs  
of the State of California  
Relating to  
\$240,255,000  
Home Purchase Revenue Bonds**

*New Issues*  
**\$54,170,000 1999 Series A (Non-AMT)  
\$86,085,000 1999 Series B (Non-AMT)**

*Remarketing*  
**\$100,000,000 1997 Series C (AMT)**

**INTRODUCTION**

This Official Statement is being furnished to provide information in connection with the sale of the Department of Veterans Affairs of the State of California (the "Department") Home Purchase Revenue Bonds, 1999 Series A (the "1999 Series A Bonds") and Home Purchase Revenue Bonds, 1999 Series B (the "1999 Series B Bonds"; and together with the 1999 Series A Bonds, the "Offered 1999 Revenue Bonds" ) and the remarketing of the Department's Home Purchase Revenue Bonds, 1997 Series C (the "1997 Series C Bonds"). (The Offered 1999 Revenue Bonds and the 1997 Series C Bonds are referred to collectively as the "Offered Revenue Bonds".)

The Offered Revenue Bonds were or are being issued pursuant to (1) the Veterans' Revenue Debenture Act of 1970, as amended (the "Act"), constituting Chapter 7 of Division 4 of the Military and Veterans Code (the "Veterans Code") of the State of California (the "State"), (2) the Resolution of Issuance for Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, adopted March 19, 1980 (the "Original Resolution"), and (3) the Eighth Supplemental Resolution Providing for Amendments and Supplements to the Resolution No. RB-1, adopted November 24, 1997, as amended (the "Eighth Supplemental Resolution"). The 1997 Series C Bonds were also issued, and the Offered 1999 Revenue Bonds are also being issued, pursuant to separate additional authorizing Series Resolutions. The Original Resolution, as amended and supplemented by the Eighth Supplemental Resolution, is referred to as "Resolution RB-1," and Resolution RB-1 and the Series Resolutions authorizing the issuance of the Offered Revenue Bonds are collectively referred to herein as the "Resolution." The State Treasurer is trustee for the Revenue Bonds (as defined below) pursuant to Resolution RB-1 (the "Trustee").

This Official Statement is not intended to provide any information with respect to any 1997 Series C Bond after its applicable Mandatory Tender Date. See "THE OFFERED REVENUE BONDS—Mandatory Tender of 1997 Series C Bonds."

In addition to the 1997 Series C Bonds, the Department has previously issued under Resolution RB-1 its 1997 Series A Bonds, 1997 Series B Bonds, and 1998 Series A Bonds (the "Other Prior Revenue Bonds" and, collectively with the 1997 Series C Bonds, the "Prior Revenue Bonds"). The outstanding Other Prior Revenue Bonds, the Offered Revenue Bonds and the bonds of any additional series issued under Resolution RB-1 ("Additional Revenue Bonds") are secured on a parity basis and are collectively called the "Revenue Bonds."

Revenue Bonds, including the Offered Revenue Bonds, are special obligations of the Department payable solely from, and equally and ratably secured with other Revenue Bonds by a pledge of, (i) an undivided interest in the assets of the Veterans' Farm and Home Building Fund of 1943 (the "1943 Fund") other than proceeds of Veterans G.O. Bonds (defined below) and any amounts in any Rebate Account, (ii) the Bond Reserve Account, and (iii) the Loan Loss Account.

The undivided interest in the assets of the 1943 Fund is secondary and subordinate to any interest or right in the 1943 Fund of the people of the State of California and of the holders of veterans general obligation bonds issued by the Department under any and all present and future veterans general obligation bond acts (collectively the "Veterans G.O. Bonds"). See "SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS." The Department has no taxing power. Neither the faith and credit nor the taxing power of the State of California or any political subdivision thereof is pledged to the payment of the principal of or the interest on the Offered Revenue Bonds.

Under the Department's Farm and Home Purchase Program (the "Program"), the Department acquires residential property to be sold to eligible veterans under contracts of purchase between the Department and such veterans ("Contracts of Purchase"). Such acquisitions are financed principally with the proceeds of bonds, including Veterans G.O. Bonds and Revenue Bonds. Contracts of Purchase ("Transferred Contracts") were entered into with respect to properties purchased by the Department with the proceeds of prior revenue bonds which were refunded using a portion of the proceeds of Other Prior Revenue Bonds. The balance of the proceeds of the Other Prior Revenue Bonds are being used and are expected to continue to be used to finance Contracts of Purchase ("New Prior Revenue Bonds Contracts").

See "PLAN OF FINANCE AND DEPARTMENT'S RECENT PROGRAMMATIC CHANGES" for a discussion of the purposes for issuing the Offered 1999 Revenue Bonds and of the remarketing of the 1997 Series C Bonds.

All capitalized terms used in this Official Statement and not defined herein shall have the meanings set forth in the Resolution. See "SUMMARY OF CERTAIN PROVISIONS OF THE RESOLUTION—Definitions (Section 103)."

## **PLAN OF FINANCE AND DEPARTMENT'S RECENT PROGRAMMATIC CHANGES**

### **Plan of Finance**

The plan of finance described under this heading is with respect to the Offered Revenue Bonds and the \$351,500,000 Veterans G.O. Bonds expected to be issued or remarketed in April 1999 (the "1999 Veterans G.O. Bonds") and assumes the respective issuances of such bonds. The Offered 1999 Revenue Bonds are being issued to provide moneys, or to replace and refund moneys to be used, to retire (at their maturity or mandatory tender dates or through optional redemption) certain outstanding Veterans G.O. Bonds and other Department bonds. The 1999 Series A Bonds are expected to be issued on March 30, 1999, while the 1999 Series B Bonds are expected to be issued on May 4, 1999. The 1997 Series C Bonds were issued on December 29, 1997, currently bear interest at a short-term rate and are subject to mandatory tender and remarketing on March 30, 1999. Upon remarketing, each 1997 Series C Bond will bear interest at a short-term rate to its applicable Mandatory Tender Date, at which time its interest rate can be adjusted to a long-term fixed rate to its maturity, or to a new short-term rate until a new mandatory tender date. The 1997 Series C Bonds are subject to mandatory tender (with no right to retain) on the applicable Mandatory Tender Date set forth on the inside front cover page.

\$80,000,000 aggregate principal amount of 1999 Veterans G.O. Bonds is expected to be issued as fixed rate long-term bonds in order to replace and refund an amount of \$51,500,000 outstanding Veterans G.O. Bonds and to replace and refund an amount of \$28,500,000 Veterans G.O. Bonds on their mandatory tender dates.

The balance of the 1999 Veterans G.O. Bonds represent a short-term remarketing of outstanding Veterans G.O. Bonds issued in 1997 at short-term interest rates and subject to mandatory

tender on the remarketing date (the "Series BJ Bonds"). The Offered 1999 Revenue Bonds and the 1999 Veterans G.O. Bonds are separate bond issues, are not interdependent, and are not treated as a single issue for federal income tax purposes. The 1997 Series C Bonds and the Series BJ Bonds, however, are, together with the Other Prior Revenue Bonds and other outstanding Veterans G.O. Bonds, treated as a single issue for federal income tax purposes. However, in all other respects the 1997 Series C Bonds and the Series BJ Bonds are separate bond issues and are not interdependent.

The issuances of the Offered 1999 Revenue Bonds and the 1999 Veterans G.O. Bonds and certain federal tax-related reallocations are expected to result in approximately \$182,700,000 becoming available for new Contracts of Purchase. These available moneys will be in addition to moneys also made available to finance new Contracts of Purchase through the issuance of the Other Prior Revenue Bonds and other Veterans G.O. Bonds in 1997 and 1998. In addition, proceeds of the 1997 Series C Bonds and Series BJ Bonds will become available to finance new Contracts of Purchase only when and if the interest rates on such bonds are adjusted to fixed interest rates to their respective maturities. See Exhibit E—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Contracts of Purchase—Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments."

#### **Department's Recent Programmatic Changes**

In the past two years, the Department has completed a number of significant changes to the Program. The Department's principal goals have been to lower the interest rate on existing Contracts of Purchase, provide an interest rate on new Contracts of Purchase which more closely reflects its borrowing costs, better service Contracts of Purchase to reduce real estate losses, obtain mortgage insurance or guaranties to reduce exposure to future real estate losses, increase accessibility by reducing down payment requirements for borrowers and allowing mortgage brokers to originate Contracts of Purchase, and revamp the various insurance products the Department offers to veterans with Contracts of Purchase.

Amendments made in 1998 to the Veterans Code eliminated the uniform interest rate requirement for Contracts of Purchase executed on and after January 1, 1999 and permit the Department to establish fixed interest rates or variable interest rates for these Contracts of Purchase. The interest rates established can be different for different Contracts of Purchase. However, the Veterans Code still requires that all Contracts of Purchase originated prior to January 1, 1999 bear a uniform interest rate which is subject to periodic adjustment. (There are statutory exceptions to the uniform rate requirement but these exceptions have little impact on the Program.) The new Contracts of Purchase to be financed with moneys allocable to the Offered 1999 Revenue Bonds (the "New 1999 Contracts") will be, and New Prior Revenue Bonds Contracts originated after January 1, 1999 are being, originated under the new statutory provisions. The current interest rates for newly originated Contracts of Purchase are 5.95% per annum for Contracts of Purchase financed with Qualified Mortgage Bond Proceeds, and 6.65% per annum for all other Contracts of Purchase. These rates are subject to change by the Department. See "THE PROGRAM—Qualifying Veterans Status—Federal Tax Code."

The current uniform interest rate on approximately 98% of the existing Contracts of Purchase is 6.95% per annum, reduced during 1998 from 8.0% per annum. The Department believes that, in the past, the high 8.0% interest rate reduced demand for new Contracts of Purchase. In late 1997, the Department began a series of steps which restructured a large part of the outstanding indebtedness which financed the Program. The restructuring has enabled the Department to lower the interest rate on existing Contracts of Purchase. Legislation effective January 1, 1998 expanded veteran eligibility under State law to include Early Vietnam Veterans and Peacetime Veterans (defined below under "THE PROGRAM—Qualifying Veteran Status—Veterans Code"). Prior to

January 1, 1999, Contracts of Purchase were originated only by the Department. Recent revisions to the Veterans Code allow the Department to require a 1% loan origination fee. As a result, the Department has begun to allow loan origination through mortgage brokers certified to participate by the Department. The Department expects that this eligibility expansion, together with the lowered interest rates on Contracts of Purchase, lowered down-payment requirements, and expanded marketing efforts through the use of mortgage brokers, will increase Program demand.

The Department has undertaken a series of steps designed to address real estate losses and loss exposure. It has reorganized its loan servicing and updated its automated loan accounting and servicing functions. It has set aside additional reserves for loan losses. It has obtained primary mortgage insurance (with a deductible) for a large portion of the existing Contracts of Purchase with high loan-to-value ratios, and is obtaining loan guaranties from the United States Department of Veterans Affairs ("USDVA") for most new Contracts of Purchase with high loan-to-value ratios. There can be no assurance, however, that the Department can continue to obtain mortgage insurance or guaranties on terms and at prices acceptable to the Department.

The Veterans Code and/or long-standing Department policies have called for the Department to provide casualty and life and disability insurance for veterans with Contracts of Purchase. During the period that the Department self-insured this liability, the Department experienced significant losses. Over the past few years the Department has undertaken steps to reduce its losses, including obtaining outside providers for some portions of these various types of insurance.

Additional information regarding the Department's programmatic changes is set forth under "THE PROGRAM." For additional discussion of qualifying veterans and interest rates on Contracts of Purchase, see, respectively, "THE PROGRAM—Qualifying Veteran Status" and "—Contracts of Purchase" below. For additional discussion of real estate losses, see "SELECTED FINANCIAL DATA OF THE 1943 FUND AND DEPARTMENT'S DISCUSSION" and "THE PROGRAM—Loan Insurance." For additional discussion of the Department's insurance programs, see "THE PROGRAM—Property and Life and Disability Insurance" below.

## **THE DEPARTMENT**

### **General**

In 1921 the California Legislature created the Veterans' Welfare Board and the Program. The Department of Veterans Affairs became the successor to the Veterans' Welfare Board under the Farm and Home Purchase Act of 1943. The Department is a subdivision of the State and constitutes a public corporation. One of the Department's basic objectives is to afford to eligible veterans the opportunity of acquiring homes with long-term low-interest financing provided under the Program.

The California Veterans Board ("Board") determines the policies for all operations of the Department. The Board is composed of seven members: the Secretary of Veterans Affairs and six public members appointed by the Governor of the State for respective terms of four years. All of the members of the Board must be veterans, and membership is subject to confirmation by the State Senate. One of these members must be retired from the active or reserve forces of the United States military service. There are currently two vacancies on the Board.

There are four principal divisions within the Department: the Division of Veterans Services, the Division of Administration, the Veterans' Home Division and the Division of Farm and Home Purchases. The Program is administered by the Division of Farm and Home Purchases with support from the Division of Administration and other Department support units. See "THE PROGRAM."

## **Administration**

In addition to its headquarters in Sacramento, the Division of Farm and Home Purchases maintains field offices located throughout the State. These local offices, in addition to providing information to all veterans concerning the Program, are responsible for Contract of Purchase originations and the initial collection and evaluation of data regarding applicants for the Program and the property to be acquired under the Program. This includes an examination as to the qualification of veterans to participate in the Program, a credit analysis, an appraisal of properties and the initial processing of the veteran's application for a Contract of Purchase.

Final processing and servicing of the Contracts of Purchase are performed by the Department at its headquarters and entail Contract of Purchase accounting, insurance and property damage claims adjustment and services, Contract of Purchase alterations and contract performance services. The Department has recently begun to allow Contracts of Purchase origination by mortgage brokers and has engaged the temporary services of an outside loan servicing company, Leader Mortgage Company ("Leader"), until its new Contract of Purchase monitoring computer system, the Integrated Loan Processing and Financial Information System, becomes operational, expected to occur by June 30, 1999. General administration of the Program, including fiscal, legal, personnel and other administrative functions, is also performed at the Department's headquarters. As of September 30, 1998 the Department's Farm and Home Purchases Division had a staff of 114 persons.

The Secretary and other staff personnel of the Department principally responsible for the administration of the Program are listed below. The Secretary is appointed by the Governor of the State, serves at the pleasure of the Governor, and must be a veteran. There is currently a vacancy in the office of Chief Counsel.

*James R. Ramos*  
*Secretary of Veterans Affairs*

Appointed to his position on January 4, 1999 by Governor Gray Davis, Secretary Ramos comes to the Department with an extensive background in veterans advocacy and small business management. A 1960 graduate of the United States Military Academy at West Point, New York, Secretary Ramos holds Master of Science degrees in System Engineering from Arizona State University and in Public Policy Analysis from California State University, Sacramento. A retired United States Army officer, Secretary Ramos served two tours of duty in Vietnam.

After leaving the Army, Secretary Ramos became a principal in two small businesses, CR Communications and Graphic Design and James R. Ramos Associates, a technical consulting firm. He remained a principal in those firms until assuming his current public duties. Throughout his business career, Secretary Ramos has been an active leader in the effort to make disabled veteran business owners competitive participants in the public contracting arena. He is the founder of the Disabled Veteran Business Enterprise Network. Republican Governor Pete Wilson named Secretary Ramos the *Small Business Person of 1994*.

*Tomas Alvarado*  
*Undersecretary of Veterans Affairs*

Undersecretary Alvarado brings to his position a career-long commitment to veterans issues. Mr. Alvarado has an extensive background in public policy development at every level of government. For the past quarter century he has worked in county government and with the State Legislature and the United States Senate as a member of several public policy staffs. In addition to significant local and legislative experience, Mr. Alvarado has a strong background within the Executive Branch of State government. From 1991 to 1995, Mr. Alvarado served as Deputy

Director of Veterans Affairs for then-Governor Wilson. In this position, Mr. Alvarado had as one of his responsibilities oversight of the Program. Mr. Alvarado is a decorated United States Marine veteran of the Vietnam conflict. Mr. Alvarado is a graduate of San Jose State University.

*Bruce Thiesen*

*Deputy Secretary for Operations*

Like Secretary Ramos, Deputy Secretary Thiesen is a Vietnam-era Army veteran with a long history as a veterans activist. Mr. Thiesen is an independent agribusinessman with more than 30 years of broad experience in farm management, farm labor acquisition and benefits administration. Mr. Thiesen served as National Commander of the American Legion in 1993-1994 and from 1995 through 1998 he was appointed by the Secretary of the United States Department of Veterans Affairs as a member of the Veterans Advisory Committee on Rehabilitation. In addition to his work on behalf of veterans, Mr. Thiesen is involved in a number of other community and philanthropic efforts.

*Curtis Howard*

*Deputy Secretary, Administration since May 1998*

Deputy Secretary Howard is a United States Air Force veteran who graduated from California State University, Sacramento in 1976 after completing the requirements for a teaching credential. He taught in the State public school system for several years, then moved into State government service where he has worked for over 19 years. He has performed a wide variety of assignments including computer programming and systems design, financial analysis, and health and safety officer duties. During the last seven years Mr. Howard has served in a number of senior level financial and program management positions with the State Department of Social Services (CDSS). While the Assistant Deputy Director for the Welfare Programs Division at CDSS, Mr. Howard was one of nine individuals selected to serve on the Governor's Welfare Reform Task force.

*Sheryl A. Schmidt*

*Deputy Secretary of Women Veterans Affairs since November 1996*

After leaving the accounting firm of Touche Ross (Deloitte & Touche) in 1987, Deputy Secretary Schmidt began her state career at the State Controller's Office as a Certified Public Accountant (CPA). In 1995, she accepted the newly created position of Chief of Audits at the Department and developed the Internal Audit Division. In 1996, the Governor of California appointed United States Air Force Veteran Sheryl Schmidt as the Deputy Secretary of Women Veterans Affairs. Ms. Schmidt holds a Bachelor's degree in management from St. Leo's College in Florida, a Master's of Business Administration (MBA) from California State University Sacramento, and a CPA license from the California State Board of Accountancy.

*Mike Madalo*

*Chief, Farm and Home Purchases Division since April 1997*

Mr. Madalo was appointed as Chief of the Farm and Home Purchases Division on April 1, 1997. He graduated in 1962 from the U.S. Naval Academy, Annapolis, Maryland, and holds a Bachelor of Science degree in Engineering. He served on active duty in the United States Marine Corps from 1962 to 1966 as a fighter bomber pilot in Vietnam. Mr. Madalo held positions, including Plant Manager, General Manager, and Marketing Manager, with the American Cyanamid Company. He was Vice President in charge of Operations for LAMAU, Inc., in Minneapolis, Minnesota; President/Owner of Empire Aire Aviation, Inc., in Fresno, California; President of Sun Laboratories of Atlanta, Inc., in Atlanta, Georgia; and Owner/President of PMI Consulting, in Fair Oaks, California.



*Kandis L. Mendonsa*

*Chief, Bond Finance Division since May 1998*

Ms. Mendonsa brings to her current position more than a quarter century of service in California state government. For most of that time, she has worked exclusively in the area of financial management. Prior to joining the Department in 1998, Ms. Mendonsa was employed for 10 years by the Department of Social Services and for 12 years at the State Department of Corrections. While at Corrections, among Ms. Mendonsa's responsibilities was the management of a \$4 billion tax exempt bond program for the construction of youth and adult correction facilities.

#### **Year 2000 Issues**

Many existing computer programs used by the Department, its third-party vendors (which include investment contract providers), the Trustee, and The Depository Trust Company ("DTC"), have used only two (2) digits to identify a year in the date field and, if not remediated, such systems could fail or create erroneous results by the year 2000. Executive Order W-163-97 established that year 2000 solutions are a State priority. In keeping with the details of the order, the Department has issued a Year 2000 Compliance Policy and is taking steps intended to ensure that the Department's automated processes accurately perform all date related processing functions.

In its daily operations, the Department uses computer systems of other State departments for Statewide administrative functions, computer applications developed by outside vendors for the Department, and computer software which is widely available commercially. The State is addressing year 2000 compliance issues with respect to the Statewide administrative functions which the Department utilizes. In 1997, the Department initiated a Request for Proposal ("RFP") for a fully Integrated Loan Processing and Financial Information System, which, when operational, will be the mechanism used by the Department to manage its portfolio of Contracts of Purchase. The system selected is utilized by several other state housing finance agencies throughout the country. The system developer demonstrated to the Department during the RFP process that the system is year 2000 compliant. The Department is currently implementing and testing the new system which is expected to be fully functional by June 30, 1999. To the extent that a manufacturer of any of the widely available commercial software packages used by the Department in its daily operations does not make satisfactory representations regarding year 2000 compliance issues, the Department intends to replace such software packages with new software packages with respect to which such representations have been made or which have demonstrated year 2000 compliance.

The Department has required that all private contractors, consultants, and vendors who provide services or support functions to the Program, such as loan servicing and insurance, provide the Department either with assurance that they are year 2000 compliant, or with their plans to become year 2000 compliant and their time frames for achieving such compliance. Any failure by some or all of these parties to become year 2000 compliant may have a material negative impact on the Department's operations or financial status.

Department income is generated from two principal sources: principal and interest payments on Contracts of Purchase and earnings on investments. Payments from these sources are used to pay Department expenses, debt service on Revenue Bonds, and reimbursement of the State General Fund for debt service on Veterans G.O. Bonds. While some of the computer-assisted monitoring relied upon by the Department could possibly be done manually in case of a system failure, the Department has not identified an effective manual substitution for computer-assisted monitoring of its portfolio of Contracts of Purchase.

The Trustee is responsible for transmitting principal, purchase price, and interest payments on Revenue Bonds to the registered owners of Revenue Bonds. DTC is (in the case of the Offered

1999 Revenue Bonds, will be) the registered owner of the Revenue Bonds, and payments of principal and interest on Revenue Bonds is payable by the Trustee to DTC, and by DTC or its Participants to beneficial owners. Therefore, timely payment and receipt of principal and purchase price of and interest on the Offered Revenue Bonds after January 2000 are dependent on the successful functioning of the payment systems of both the Trustee and DTC. The Trustee has reported that, as of December 31, 1998, its systems for bond payments were fully year 2000 compliant. See "BOOK-ENTRY ONLY SYSTEM—DTC's Year 2000 Efforts" for information provided by DTC regarding its year 2000 compliance efforts.

The Department has not independently reviewed the assurances of other parts of State government, the developers of the Department's computer systems (other than its Integrated Loan Processing and Financial Information System), DTC and the Trustee, and will not independently review the assurances made by its critical vendors (other than the developer of its Integrated Loan Processing and Financial Information System). The State Controller's Office has reported that it had completed the necessary year 2000 remediation projects for the State fiscal and accounting systems by December 31, 1998, consistent with the Governor's Executive Order and that its final steps of testing will be completed during 1999. The Department, the Trustee, other parts of State government, the developers of its computer systems, the developers of widely available commercial software packages used by the Department, and the critical vendors may each subsequently discover areas of non-compliance.

The Department is not presently aware of any costs to achieve year 2000 compliance that will have a material negative impact on the Department's operations or financial status; however, the Department can give no assurance that any subsequently discovered non-compliance will not have such material negative impact.

Failure by one or more of the Department, the Trustee, other parts of State government, the developers of the Department's computer systems, DTC, the developers of the widely available commercial software packages used by the Department, and the critical vendors to be in year 2000 compliance could have a materially adverse effect on the programmatic and financial functionings of the Department.

### **LAO Reports and Governor's Budget**

The Legislative Analyst's Office for the State of California (the "LAO"), on January 16, 1998, issued a report entitled "Rethinking the Cal-Vet Loan Program." On February 16, 1999, the LAO issued an analysis of the proposed Governor's Budget 1999/2000, which analysis included a discussion of the Department. (The report and the analysis are referred to collectively as the "LAO Reports.") The stated purpose of the LAO is to provide analysis and nonpartisan advice to the California Legislature on fiscal and policy issues. The LAO is overseen by the Joint Legislative Budget Committee, a 14-member bipartisan committee composed of an equal number of State Assembly and State Senate members.

In the LAO Reports, the LAO analyzed the historical and recent financial performance and lending activities of the Department and made various recommendations. The LAO Reports described the financial losses experienced by the Department, the increasing rate of repayment of Contracts of Purchase, and the decreased lending activity in recent years. The LAO Reports attributed the decreased lending activity principally to more attractive loan programs available from other sources and to a dwindling population of eligible veterans. The budget analysis stated that the Department's completed and proposed programmatic changes (including changing from the uniform interest rate) have improved borrower demand, although less than the Department had projected, and the Department's bond restructuring program, implemented with the sale of over \$1.4 billion of Veterans G.O. Bonds and Revenue Bonds in 1997 and 1998, had improved the

Department's financial operations. However, the LAO's analysis of the interests of the State and of the future needs of veterans and funding sources led to several recommendations, which included increased oversight of the Department, ending new loan origination after the year 2007, and use of "surplus" Department moneys for the benefit of veterans and State taxpayers. The 1998 report stated that any redirection of "surplus funds should be accomplished carefully by means that ensure that all obligations of the [S]tate to Bondholders are met." Any further actions on the LAO Reports would result from legislative changes that would be proposed by the Legislature and signed by the Governor. In addition, the LAO budget analysis states that any such use of surplus funds would have to be authorized through a ballot measure.

In his proposed budget for Fiscal Year 1999-2000, Governor Davis cites the 1998 report when discussing the Department, and refers to "a basic dilemma: there is a declining interest or need for home loans and an increasing need for other services for veterans." The Governor listed several steps intended to improve the operation of State programs for veterans. Those most relevant to the Program are (a) appointment of an internal auditor for the Department, (b) a request to the Bureau of State Audits to conduct a fiscal and program compliance audit of the Program, which, with other studies, will lay the groundwork for corrective action, and (c) direction to the Secretary of Veterans Affairs to report within 6 months to the Governor on the need for further restructuring of the Program and on ways that the "surplus funds in the home program" might be redirected to other pressing needs of veterans.

The financial performance of and loan origination by the Department and its recent programmatic changes are discussed elsewhere in this Official Statement. The Department does not believe that either termination of loan originations after 2007 or use of Department moneys to fund other programs, if either or both of these policies were implemented, would have an adverse impact on the Department's ability to pay scheduled principal and purchase price of and interest on any Veterans G.O. Bonds or Revenue Bonds. While the Legislature could enact any or all of the recommendations in the LAO Report, use of moneys in the 1943 Fund for veterans benefits outside of the Program may be subject to approval by the electorate of the State and may also be subject to other legal restrictions.

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## **SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS**

### **General**

The Revenue Bonds are special obligations of the Department payable solely from, and equally and ratably secured with other Revenue Bonds by a pledge of, (i) an undivided interest in the assets of the 1943 Fund other than proceeds of Veterans G.O. Bonds and any amounts in any Rebate Account, (ii) the Bond Reserve Account, and (iii) the Loan Loss Account. **State law provides that such undivided interest in the assets of the 1943 Fund is secondary and subordinate to the obligation of the 1943 Fund to pay or reimburse debt service on the Veterans G.O. Bonds, as described below. The Department has no taxing power. Neither the faith and credit nor the taxing power of the State of California or any political subdivision thereof is pledged to the payment of the principal of or the interest on the Revenue Bonds.**

### **The 1943 Fund**

The components of the 1943 Fund are (i) proceeds derived from the sale of Revenue Bonds, (ii) proceeds of Veterans G.O. Bonds, (iii) amounts receivable under all Contracts of Purchase and from sales of properties subject to canceled Contracts of Purchase, (iv) temporary investments, cash and funds, and (v) certain other miscellaneous assets. Proceeds of Veterans G.O. Bonds may not be applied to payment of principal of, and interest or any redemption premium on, the Revenue Bonds. The holders of Revenue Bonds are not entitled to compel the sale of Contracts of Purchase and the properties to which they relate, but are entitled to receive payment out of the Revenues derived from those Contracts of Purchase and properties, subject to the prior claims, if any, of the Veterans G.O. Bonds.

In addition to financing Contracts of Purchase and paying or reimbursing of debt service on the Veterans G.O. Bonds and Revenue Bonds, as described below, moneys in the 1943 Fund are used to pay administrative costs of the Department, and to fund certain losses from and reserves for property insurance and life and disability insurance described below under "THE PROGRAM—Property and Life and Disability Insurance."

While the 1998 Financial Statement for the 1943 Fund reflects an increase in retained earnings, the Program has experienced significant losses during recent fiscal years in the retained earnings in the 1943 Fund. For additional information, see below "SELECTED FINANCIAL DATA OF THE 1943 FUND AND DEPARTMENT'S DISCUSSION" and also see Exhibit A—"FINANCIAL STATEMENTS OF THE 1943 FUND FOR FISCAL YEARS 1997 AND 1998 AND INDEPENDENT AUDITOR'S REPORT."

The Act and the Veterans Code provide that the undivided interest created by Resolution RB-1 in favor of the holders of Revenue Bonds in the assets of the 1943 Fund is secondary and subordinate to the interest of the people of the State and the holders of Veterans G.O. Bonds. Moneys in the 1943 Fund must be paid, on the debt service payment dates of Veterans G.O. Bonds, to the General Fund in the amount of the principal of (whether at maturity or upon redemption or acceleration), and premium and interest on Veterans G.O. Bonds then due and payable (other than debt service payable from the proceeds of refunding bonds). Debt service on Veterans G.O. Bonds is payable from the General Fund, even if the amount transferred from the 1943 Fund to the General Fund is less than such debt service amount. The balance remaining unpaid must be transferred to the General Fund out of the 1943 Fund as soon thereafter as it becomes available, together with interest thereon at the rate borne by the applicable Veterans G.O. Bonds, compounded semiannually. Until such amounts are repaid to the General Fund, no payments may be made on the Revenue Bonds other than from amounts then in the Bond Reserve Account and the

Loan Loss Account. These rights with respect to the 1943 Fund do not grant any lien on the 1943 Fund or the moneys therein to the holders of any Veterans G.O. Bonds.

As of December 31, 1998, there were outstanding \$2,835,020,000 aggregate principal amount of Veterans G.O. Bonds and \$269,135,000 aggregate principal amount of Revenue Bonds. As of December 31, 1998, \$176,835,000 of Veterans G.O. Bonds are authorized but not issued, and the Department may in the future seek voter approval for additional amounts of Veterans G.O. Bonds. The 1999 Veterans G.O. Bonds will not use any of such authorized amount. Under the Act, Revenue Bonds in an aggregate principal amount not to exceed \$1,500,000,000, at any given time, may be outstanding. The Legislature may increase the amount of Revenue Bonds issuable under the Act or may decrease such amount to an amount not less than the amount of Revenue Bonds then outstanding. See "PLAN OF FINANCE AND DEPARTMENT'S RECENT PROGRAMMATIC CHANGES" for information about the issuance of the 1999 Veterans G.O. Bonds. Additional information about outstanding Veterans G.O. Bonds and Revenue Bonds is in Exhibit E—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Veterans G.O. Bonds and Revenue Bonds."

See "THE DEPARTMENT—LAO Reports and Governor's Budget" for a discussion of suggestions that surplus moneys in the 1943 Fund be applied to finance benefits for veterans outside the Program.

See "PLAN OF FINANCE AND DEPARTMENT'S RECENT PROGRAMMATIC CHANGES" for a discussion of the Department's reductions of the interest rates on existing Contracts of Purchase and the interest rate for new Contracts of Purchase. For additional information regarding the existing interest rates of, and setting interest rates on, Contracts of Purchase, see "THE PROGRAM—Contracts of Purchase" and Exhibit E—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Contracts of Purchase."

### **Bond Reserve Account**

Resolution RB-1 requires the establishment and, from available Revenues, maintenance of a Bond Reserve Account in an amount at least equal to the Bond Reserve Requirement. Resolution RB-1 creates a first lien in favor of the holders of the Revenue Bonds on amounts in the Bond Reserve Account which are not in excess of the Bond Reserve Requirement (as defined below). Resolution RB-1 establishes the Bond Reserve Requirement as of any date of calculation to be an amount equal to the aggregate of the amounts established by each Series Resolution authorizing Revenue Bonds, at least equal in the aggregate to 3% of the aggregate Outstanding principal amount of the Revenue Bonds with interest rates fixed to maturity (the "Bond Reserve Requirement"). For purposes of calculating the Bond Reserve Requirement, the Resolution established with respect to the Prior Revenue Bonds and the Offered 1999 Revenue Bonds an amount equal to 7.0% of the Outstanding principal amount of, as applicable, the Other Prior Revenue Bonds and the Offered 1999 Revenue Bonds. Amounts in the Bond Reserve Account shall be used solely for the purposes of paying the principal of and interest on the Revenue Bonds or making Mandatory Sinking Account Payments (but only in the event that no other moneys other than certain moneys in the Revenue Bond Series Bond Proceeds Subaccounts or Revenue Bond Series Proceeds Recycling Subaccounts are available therefor). Resolution RB-1 directs that amounts on deposit in the Bond Reserve Account as of any date in excess of the Bond Reserve Requirement be transferred at the request of the Department to the Loan Loss Account, the Revenue Account or the Proceeds Account.

As of December 31, 1998, the Bond Reserve Requirement was \$11,839,450 and the amount on deposit in the Bond Reserve Account was at least equal to the Bond Reserve Requirement.

Although the Department used cash to fund the Bond Reserve Requirement with respect to the Other Prior Revenue Bonds (and expects to use cash to fund the Bond Reserve Requirement with respect to the Offered 1999 Revenue Bonds), the Series Resolutions authorizing the issuance of the Other Prior Revenue Bonds and the Offered Revenue Bonds provide that Cash Equivalents may replace such cash in the future. Resolution RB-1 permits Series Resolutions authorizing Additional Revenue Bonds to provide that Cash Equivalents be used to fund the Bond Reserve Requirement with respect to the Series of Bonds so authorized.

Exhibit B includes audited financial statements regarding the Bond Reserve Account. Information for fiscal year 1997 in said financial statements, however, reflects the Bond Reserve Account prior to significant amendments made to the Original Resolution by the Eighth Supplemental Resolution.

#### **Loan Loss Account**

There are currently no amounts on deposit or required to be on deposit in the Loan Loss Account. No deposits will be required in connection with the issuance and remarketing of the Offered Revenue Bonds.

Resolution RB-1 requires that the amount on deposit in the Loan Loss Account must be at least equal to the Loan Loss Requirement before the Offered 1999 Revenue Bonds or any Additional Revenue Bonds may be issued. Resolution RB-1 establishes the Loan Loss Requirement, as of any date of calculation, as an amount equal to the amount established in the then-current Cash Flow Statement, as described below under "Cash Flow Statements and Program Operating Procedures." The Cash Flow Statement which will be in effect upon the issuance of the Offered 1999 Revenue Bonds is not expected to establish a Loan Loss Requirement. Resolution RB-1 provides that, pursuant to the Program Operating Procedures, moneys held for the credit of the Loan Loss Account as of any date at the request of the Department will be transferred to the Revenue Account, the Bond Reserve Account, the Proceeds Account or any Revenue Subaccount established with respect to the Veterans G.O. Bonds. Amounts in the Loan Loss Account will be used to pay the principal of and interest on the Revenue Bonds or to make Mandatory Sinking Account Payments.

Resolution RB-1 permits Series Resolutions authorizing future series of Revenue Bonds to provide that Cash Equivalents be used to fund the Loan Loss Requirement with respect to the Series of Bonds so authorized.

#### **Cash Flow Statements and Program Operating Procedures**

Resolution RB-1 requires that the Department file a Cash Flow Statement with the Trustee (i) upon adoption of a Series Resolution authorizing Additional Revenue Bonds or amending Resolution RB-1 or any Series Resolutions or Supplemental Resolution, (ii) upon the issuance of any series of Veterans G.O. Bonds, (iii) when required pursuant to any Series Resolution or Supplemental Resolution, (iv) upon any change in the Program Operating Procedures described below, and (v) in connection with complying with the requirements described below under "SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS—Maintenance of Fund Parity." Resolution RB-1 permits the Department to file a new Cash Flow Statement at any time. Resolution RB-1 requires that any Cash Flow Statement be the subject of a Rating Confirmation if it does not include all the scenarios included in the Cash Flow Statement previously on file with the Trustee.

Resolution RB-1 requires that a Cash Flow Statement consist of a Certificate of the Department containing the conclusion of an Authorized Representative of the Department that projected Revenues will be sufficient to provide for timely payments of interest and principal on the Revenue

Bonds and Expenses, under each of the scenarios included in the cash flow projections attached thereto. Under Resolution RB-1, "Revenues" means all moneys received by or on behalf of the Department representing (i) principal and interest payments on the Contracts of Purchase including all prepayments representing the same and all prepayment premiums or penalties received by or on behalf of the Department in respect of the Contracts of Purchase, (ii) interest earnings received on the investment of amounts to the extent deposited in the Revenue Account under Resolution RB-1, (iii) amounts transferred to the Revenue Account from the Bond Reserve Account or the Loan Loss Account, and (iv) any other amounts payable by parties executing Contracts of Purchase or private participants in the Program or related to recoveries on defaulted Contracts of Purchase, including origination and commitment fees, servicing acquisition fees, and Liquidation/Insurance Proceeds, except to the extent not included as "Revenues" pursuant to the provisions of any Series Resolution.

Resolution RB-1 requires that a Cash Flow Statement will (i) take into account the financial position of the 1943 Fund, the Bond Reserve Account and the Loan Loss Account as of the stated starting date of the projection, (ii) reflect all the significant transactions that have occurred in the period commencing with such starting date and ending with a date no more than ninety (90) days prior to the date of such projections, (iii) be consistent with Resolution RB-1 and (iv) assume compliance with the then-current Program Operating Procedures. For each scenario included therein, Resolution RB-1 requires that the Cash Flow Statement set forth the assumptions on which it is based including, without limitation, the following:

- (i) the timing and terms of issuance or remarketing of Revenue Bonds and Veterans G.O. Bonds;
- (ii) the timing of the acquisition of Contracts of Purchase and the interest rates thereon and maturities thereof;
- (iii) the timing and amounts of the receipt of payments of scheduled principal of and interest on Contracts of Purchase;
- (iv) the timing and amounts of prepayments on Contracts of Purchase;
- (v) the timing and amount of defaults on Contracts of Purchase and disposition or recovery prices of defaulted Contracts of Purchase, which assumption may be based on a specified model of default frequency and loss severity as a function of Contract of Purchase portfolio characteristics;
- (vi) the investment return on Accounts and subaccounts, to the extent that amounts on deposit will be subject to an investment agreement;
- (vii) the performance by the Department's counterparty with respect to obligations under an enhancement agreement or arrangement for Supplemental Contract of Purchase Coverage or investment of funds;
- (viii) the types of Primary Contract of Purchase Coverage and Supplemental Contract of Purchase Coverage; and
- (ix) the Loan Loss Requirement.

According to Resolution RB-1, the Department will not be in default under Resolution RB-1 merely because a Cash Flow Statement shows that projected Revenues will be insufficient to provide for timely payments of interest on and principal of the Revenue Bonds and Expenses, but is required to take all reasonable actions to eliminate such deficiency.

The Program Operating Procedures are operating policies of the Department governing discretionary activities under Resolution RB-1. Resolution RB-1 requires the Department to

administer the Program and perform its obligations under Resolution RB-1 in accordance in all material respects with the then-current Program Operating Procedures. The Program Operating Procedures may be amended if (1) a Cash Flow Statement is delivered to the Trustee, and (2) an opinion of nationally recognized bond counsel is delivered to the Trustee to the effect that such amendment or action taken pursuant to such amendment will not affect the exemption of interest on the Revenue Bonds from the gross income of the holders thereof for federal income tax purposes.

#### **Cash Flow Statements to be Delivered in Connection with the Offered Revenue Bonds**

As a condition to the issuance of the 1999 Series A Bonds and the remarketing of the 1997 Series C Bonds, the Department will provide the Trustee with its Cash Flow Statement in the form required by Resolution RB-1. The Cash Flow Statement will consist of the conclusion by an Authorized Representative of the Department that projected Revenues will be sufficient to provide for timely payments of interest and principal on the Revenue Bonds and Expenses, under each of the scenarios included in the cash flow projections attached thereto (the "Issuance Cash Flow Projections"). The Issuance Cash Flow Projections will be prepared by cfX Incorporated ("cfX"), pursuant to its engagement as Quantitative Consultant to the Department. The Issuance Cash Flow Projections and the conclusions of cfX contained in its accompanying cash flow letter will be based solely on information provided to cfX by the Department and the Trustee and certain assumptions provided to cfX by the Department and upon scenarios generally specified by the Rating Agencies to be tested; cfX makes no representation with respect to the accuracy of such information or as to the reasonableness of such assumptions and scenarios. The Department will be required to provide the Trustee with an additional Cash Flow Statement as of the delivery of the 1999 Series B Bonds, expected to be May 4, 1999. cfX expects to provide replacement cash flow projections prior to that time, but can provide no assurance that intervening events will not prevent the Department from reaching the required conclusion in such Cash Flow Statement.

The Issuance Cash Flow Projections will be based on the financial condition of the 1943 Fund as of June 30, 1998 (as presented in the audited financial statements of the 1943 Fund as of June 30, 1998) and will reflect significant financial transactions within the 1943 Fund through February 1, 1999, as explained to cfX by the Department. The Issuance Cash Flow Projections will reflect (i) the assumed delivery of the Offered 1999 Revenue Bonds and the 1999 Veterans G.O. Bonds, and the remarketing of the 1997 Series C Bonds and the Series BJ Bonds as part of the overall financing plan (but no additional future issuance of either Revenue Bonds or Veterans G.O. Bonds), and (ii) the initial application of proceeds of such bonds in accordance with the Department's expected terms of the applicable Series Resolutions. The Issuance Cash Flow Projections will assume that the 1997 Series C Bonds and the Series BJ Bonds are redeemed (and not remarketed) on their next respective mandatory tender dates.

The Issuance Cash Flow Projections will include each of the scenarios generally specified by the Rating Agencies and included in the final presentations to the Rating Agencies in connection with the Department's application for an appropriate rating on the Offered Revenue Bonds. Such scenarios reflect a combination of assumptions required by the Rating Agencies to be used with respect to future market conditions and behavior of eligible and participating veterans under such market conditions. cfX makes no representation with respect to the sufficiency of Revenues to provide for timely payments of interest and principal on the Revenue Bonds and Expenses under any scenario not presented in the Issuance Cash Flow Projections. Among other assumptions, the Issuance Cash Flow Projections will include scenarios under which:



- (i) The 1999 Series B Bonds are not issued.
- (ii) The 1999 Veterans G.O. Bonds are not issued.
- (iii) No future prepayments are received with respect to Contracts of Purchase, or, alternatively, that prepayments are received at a number of specified annualized constant prepayment rates.
- (iv) As of specified dates no additional Contracts of Purchase are funded and unexpended amounts are applied to the redemption of Revenue Bonds and Veterans G.O. Bonds.
- (v) A specified level of unreimbursed losses is incurred with respect to defaulted Contracts of Purchase.

Each scenario in the Issuance Cash Flow Projections will reflect future transactions expected to be executed by the Department and the Trustee (among others) with respect to: (i) the application for Program purposes of amounts in the Proceeds Account established under Resolution RB-1, (ii) the collection and deposit of Revenues, (iii) the investment of amounts on deposit in various Accounts in both specified and unspecified investments, (iv) the transfer of funds between Accounts, (v) the payment of Expenses, and (vi) the redemption of Revenue Bonds and Veterans G.O. Bonds. All of the scenarios included in Issuance Cash Flow Projections assume that the Department and the Trustee execute such transactions on a timely basis in conformance with the requirements of Resolution RB-1, the Series Resolutions authorizing the issuance of the Offered Revenue Bonds and future Series of Revenue Bonds, the Program Operating Procedures, and the contractual performance of providers of third party investment contracts. cfX can provide no assurance that such actions will be timely taken.

Each scenario in the Issuance Cash Flow Projections will reflect future performance by third parties under investment and insurance contracts, and will assume no default in performance. Each scenario will also assume that, with the exception of reserves and liabilities reflected on the 1943 Fund audited financial statements as of June 30, 1998, future operations of the life and disability insurance and property insurance programs offered by the Department will neither contribute to, nor require support from, the 1943 Fund.

The Cash Flow Statement and the Issuance Cash Flow Projections have not been and will not be verified for mathematical accuracy by an independent auditor.

### **Maintenance of Fund Parity**

Resolution RB-1 requires that the Department cause a calculation to be made of Fund Parity, as evidenced in a Certificate of the Department filed with the Trustee as of the last day of each Fiscal Year (and upon receipt of the audited financial statements of the 1943 Fund), or more frequently in the discretion of the Department. If any such calculation shall not reflect that Fund Parity at least equals 50% (or such other percentage set forth in the Program Operating Procedures provided that any percentage which is less than 50% shall be the subject of a Rating Confirmation (see below)) (the "Applicable Fund Parity Percentage") of the then Outstanding principal amount of Revenue Bonds, all Revenues in excess of Accrued Debt Service on the Revenue Bonds and Veterans G.O. Bonds shall thereafter be applied to redeem Revenue Bonds of the Series and in the manner reflected in a current Cash Flow Statement, until (and if) the Department files with the Trustee a new Certificate of the Department reflecting a calculation of Fund Parity that at least equals such Applicable Fund Parity Percentage; provided, further, however, that no such Cash Flow Statement and no such redemption shall be required if the Department shall have provided a Rating Confirmation to the Trustee. Since it has received the required Rating Confirmation, the Department has reduced the percentage stated in the foregoing sentence from 50% to 25%.

Under Resolution RB-1, "Fund Parity" means, on any determination date, (a) an amount equal to the difference between (i) all assets in the 1943 Fund and in the Accounts established under Resolution RB-1 and any Series Resolution or Supplemental Resolution, and (ii) the principal amount of all Revenue Bonds Outstanding and all Veterans G.O. Bonds outstanding (plus accrued interest) reduced by (b) allowances and reserves for loss coverage on Contracts of Purchase, and life and disability coverage on persons obligated under Contracts of Purchase, as specified in the Program Operating Procedures. Resolution RB-1 provides that "Accrued Debt Service" means, as of any date of determination and, as the context of Resolution RB-1 requires, with respect to all Revenue Bonds and Veterans G.O. Bonds, the sum of:

(a) the aggregate amount of scheduled interest and principal (except to the extent principal is otherwise to be redeemed pursuant to clause (b) or (c) below) to become due after such date but on or before the end of the current Debt Service Year, less the product of (i) the number of whole months remaining in the current Debt Service Year and (ii) the Monthly Debt Service Requirement;

(b) the redemption price of bonds for which notice of redemption has been issued, provided such redemption price is to be paid from amounts on deposit in the Revenue Account; and

(c) the redemption price of bonds that the Department will be obligated to redeem prior to the end of the next succeeding Debt Service Year under the terms of any Series Resolution or Supplemental Resolution or resolution of issuance governing Veterans G.O. Bonds, to the extent that such obligation arises on account of amounts on deposit in the Revenue Account.

Under Resolution RB-1, "Monthly Debt Service Requirement" means, as of any date of determination, one-twelfth of the aggregate amount of scheduled interest and principal to become due during the Debt Service Year in which such date falls, as computed on the first day of such Debt Service Year.

#### **Additional Revenue Bonds**

Resolution RB-1 permits the issuance of Series of Additional Revenue Bonds to carry out the provisions of the Act and other statutes enacted in support of the Program or to refund all or part of the Revenue Bonds then Outstanding. Any Series of Additional Revenue Bonds issued under Resolution RB-1 will be on a parity with the then Outstanding Revenue Bonds, and will be entitled to the equal benefit, protection and security of the provisions, covenants and agreements of Resolution RB-1. Additional Revenue Bonds may have interest payment dates which differ from those of the Offered Revenue Bonds. Upon the issuance of any such Series of Additional Revenue Bonds, Resolution RB-1 requires the deposit into the Bond Reserve Account and the Loan Loss Account such amounts as are necessary to increase the amounts therein to, respectively, the Bond Reserve Requirement or the Loan Loss Requirement. Such deposit may be made from the 1943 Fund, the proceeds of sale of the Series of Additional Revenue Bonds or any other lawful source, or through the use of Cash Equivalents as provided in the Series Resolution authorizing the issuance of the Series of Additional Revenue Bonds. Under Resolution RB-1, issuance of Additional Revenue Bonds is conditioned upon delivery of a Cash Flow Statement and Rating Confirmation and upon certification that no Event of Default under Resolution RB-1 shall have occurred and be continuing.

Additional Veterans G.O. Bonds (including the 1999 Veterans G.O. Bonds) authorized by the voters of the State may be issued by the State from time to time to provide funds for the Program or to refund outstanding Veterans G.O. Bonds, subject to the delivery of a Cash Flow Statement. See "SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS—The 1943 Fund" for a discussion of authorized but unissued bonds.

## **SELECTED FINANCIAL DATA OF THE 1943 FUND AND DEPARTMENT'S DISCUSSION**

### **Selected Financial Data of the 1943 Fund**

The following selected financial data of the 1943 Fund for fiscal years ended June 30, 1998 and 1997 has been derived from the financial statements of the 1943 Fund audited by Deloitte & Touche LLP, independent auditors, whose report thereon appears in Exhibit A in this Official Statement. The following selected financial data of the 1943 Fund for fiscal years ended June 30, 1996, 1995 and 1994 has also been derived from the audited financial statements of the 1943 Fund which are not included herein. This selected financial data should be read in conjunction with the financial statements and notes thereto of the 1943 Fund contained in said Exhibit A and the Department's Discussion of Financial Data contained herein.

Beginning with the fiscal year ended June 30, 1998, the financial statements of the 1943 Fund are required to reflect accounting changes required by promulgation of Statement No. 31 by the Governmental Accounting Standards Board ("GASB 31"). GASB 31 requires all investments to be reported at their fair market value (rather than book value) and investment income to be adjusted to reflect the difference between the fair market and book value of investments as either a capital gain or loss. The financial data derived from the financial statements of the 1943 Fund for FY 1994 through FY 1997 and presented in the tables above have been adjusted to reflect the impact of GASB 31 on investments and investment income so as to make such data consistent with the accounting procedures used in preparing the FY 1998 financial statements.

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**SELECTED FINANCIAL DATA OF THE 1943 FUND**  
(Thousands of Dollars)

	<u>June 30, 1998</u>	<u>Restated June 30, 1997</u>	<u>Restated June 30, 1996</u>	<u>Restated June 30, 1995</u>	<u>Restated June 30, 1994</u>
<b>ASSETS AND LIABILITIES RELATED TO LENDING AND FINANCING ACTIVITIES:</b>					
<b>CASH AND INVESTMENTS</b>					
Cash and amounts on Deposit in SMIF	325,321	317,178	295,140	306,269	1,058,832
Guaranteed Investment Contracts	938,888	365,542	475,744	591,449	326,638
Treasury Securities	<u>187,851</u>	<u>347,214</u>	<u>363,426</u>	<u>395,113</u>	<u>53,923</u>
Total	1,452,060	1,029,934	1,134,310	1,292,831	1,439,393
<b>DUE FROM VETERANS DEBENTURE REVENUE FUND</b>					
	12,686	86,279	137,141	137,166	137,108
<b>OTHER CURRENT ASSETS</b>					
	13,755	22,596	26,191	25,787	24,819
<b>NET OTHER NON-CURRENT ASSETS</b>					
	36,406	15,123	15,824	16,600	13,255
<b>CONTRACTS OF PURCHASE</b>					
Performing Contracts	2,035,879	2,154,142	2,231,994	2,356,818	2,185,107
Non Performing Contracts	<u>62,872</u>	<u>75,038</u>	<u>74,268</u>	<u>53,257</u>	<u>40,619</u>
Total	2,098,751	2,229,180	2,306,262	2,410,075	2,225,726
Allowance For Contract Losses	(22,005)	(26,412)	(15,801)	(15,066)	(16,937)
Reduction of REO to Fair Value	<u>(19,003)</u>	<u>(24,003)</u>	<u>(17,113)</u>	<u>(12,334)</u>	<u>0</u>
Total	<u>(41,008)</u>	<u>(50,415)</u>	<u>(32,914)</u>	<u>(27,400)</u>	<u>(16,937)</u>
<b>BONDS PAYABLE</b>					
General Obligation Bonds	(2,947,165)	(2,632,045)	(2,812,810)	(3,002,695)	(2,802,260)
Revenue Bonds	<u>(275,055)</u>	<u>(327,580)</u>	<u>(374,975)</u>	<u>(434,545)</u>	<u>(600,890)</u>
Total	<u>(3,222,220)</u>	<u>(2,959,625)</u>	<u>(3,187,785)</u>	<u>(3,437,240)</u>	<u>(3,403,150)</u>
<b>OTHER CURRENT LIABILITIES</b>					
	<u>(58,458)</u>	<u>(80,502)</u>	<u>(86,716)</u>	<u>(90,868)</u>	<u>(96,821)</u>
<b>Net Lending &amp; Financing Activities Assets</b>					
	<u><u>291,972</u></u>	<u><u>292,570</u></u>	<u><u>312,313</u></u>	<u><u>326,951</u></u>	<u><u>323,393</u></u>
<b>ASSETS AND LIABILITIES RELATED TO INSURANCE ACTIVITIES:</b>					
<b>LIFE AND DISABILITY COVERAGE</b>					
Deposits with Insurance Administrators	40,823	48,762	56,843	65,246	65,607
Insurance Reserves & Claims Payable	<u>(53,185)</u>	<u>(65,828)</u>	<u>(78,246)</u>	<u>(79,729)</u>	<u>(68,214)</u>
Total	(12,362)	(17,066)	(21,403)	(14,483)	(2,607)
<b>FIRE AND HAZARD COVERAGE</b>					
Net Insurance Reserves & Claims Payable	<u>(1,209)</u>	<u>(1,405)</u>	<u>(2,744)</u>	<u>(5,013)</u>	<u>(3,209)</u>
<b>Net Insurance Activities Liabilities</b>					
	<u><u>(13,571)</u></u>	<u><u>(18,471)</u></u>	<u><u>(24,147)</u></u>	<u><u>(19,496)</u></u>	<u><u>(5,816)</u></u>
<b>RETAINED EARNINGS</b>					
	<u><u>278,401</u></u>	<u><u>274,099</u></u>	<u><u>288,166</u></u>	<u><u>307,455</u></u>	<u><u>317,577</u></u>
<b>SUMMARY INFORMATION</b>					
Total Assets	3,587,000	3,377,000	3,639,000	3,916,000	3,889,000
Total Liabilities	3,309,000	3,103,000	3,351,000	3,609,000	3,571,000
Total Number of Contracts Of Purchase	35,906	39,343	42,650	47,075	48,341

**SELECTED FINANCIAL DATA OF THE 1943 FUND**  
(Thousands of Dollars)

	<u>June 30, 1998</u>	<u>Restated June 30, 1997</u>	<u>Restated June 30, 1996</u>	<u>Restated June 30, 1995</u>	<u>Restated June 30, 1994</u>
<b>NET INCOME FROM LENDING AND FINANCING ACTIVITIES:</b>					
<b>INTEREST INCOME</b>					
Interest on Contracts	162,086	175,186	182,636	181,595	185,040
Interest on Investments	74,077	67,373	79,510	76,846	83,153
Transfers of Interest From Veterans Debtenture Revenue Fund	<u>3,317</u>	<u>10,843</u>	<u>11,144</u>	<u>11,164</u>	<u>11,031</u>
Total	239,480	253,402	273,290	269,605	279,224
BOND INTEREST EXPENSE	<u>(218,757)</u>	<u>(230,871)</u>	<u>(245,971)</u>	<u>(252,792)</u>	<u>(274,271)</u>
<b>Net Interest Income(Expense)</b>	<u><b>20,723</b></u>	<u><b>22,531</b></u>	<u><b>27,319</b></u>	<u><b>16,813</b></u>	<u><b>4,953</b></u>
GASB 31 ADJUSTMENT	(4,578)	8,420	(12,580)	18,618	1,488
GAIN ON SALE OF SECURITIES	13,460				
RESTRUCTURING EXPENSES	<u>(3,068)</u>				
	<u>5,814</u>	<u>8,420</u>	<u>(12,580)</u>	<u>18,618</u>	<u>1,488</u>
<b>CONTRACTS OF PURCHASES</b>					
PMI	(1,551)				
Net loss on Sale Of REO'S	(3,128)	(8,309)	(5,510)	(2,200)	(945)
Increase In Allowance For Contract Losses	<u>(1,312)</u>	<u>(22,677)</u>	<u>(5,515)</u>	<u>(10,463)</u>	<u>(10,837)</u>
Total	(5,991)	(30,986)	(11,025)	(12,663)	(11,782)
<b>Net Lending/Financing Activities Income (Expense)</b>	<u><b>20,546</b></u>	<u><b>(35)</b></u>	<u><b>3,714</b></u>	<u><b>22,768</b></u>	<u><b>(5,341)</b></u>
<b>NET INCOME FROM ADMINISTRATIVE ACTIVITIES</b>					
Operating Revenues	1,891	2,290	1,769	2,768	1,617
Operating Expenses	<u>(20,381)</u>	<u>(20,218)</u>	<u>(18,810)</u>	<u>(17,675)</u>	<u>(18,973)</u>
<b>Net Administrative Activities Expense</b>	<u><b>(18,490)</b></u>	<u><b>(17,928)</b></u>	<u><b>(17,041)</b></u>	<u><b>(14,907)</b></u>	<u><b>(17,356)</b></u>
<b>NET INCOME FROM INSURANCE ACTIVITIES</b>					
Life and Disability Coverage	160	3,570	(5,424)	(13,781)	(1,152)
Fire and Hazard Coverage	<u>2,086</u>	<u>326</u>	<u>(538)</u>	<u>(4,202)</u>	<u>3,809</u>
<b>Net Insurance Activities Income (Expense)</b>	<u><b>2,246</b></u>	<u><b>3,896</b></u>	<u><b>(5,962)</b></u>	<u><b>(17,983)</b></u>	<u><b>2,657</b></u>
<b>TOTAL DEFICIENCY OF REVENUES AND TRANSFERS OVER EXPENSES</b>					
	<u><b>4,302</b></u>	<u><b>(14,067)</b></u>	<u><b>(19,289)</b></u>	<u><b>(10,122)</b></u>	<u><b>(20,040)</b></u>
RETAINED EARNINGS	<u>278,401</u>	<u>274,099</u>	<u>288,166</u>	<u>307,455</u>	<u>317,577</u>

## **Department's Discussion of Financial Data**

The impact of GASB 31 adjustments over the five-year period reflected in the tables above (including FY 1998) are a cumulative decrease of \$11,368,000 in the deficiency of revenues over expenses and cumulative increase of the same amount in retained earnings.

The 1943 Fund, which is the sole operating fund for the Program, reflects a retained earnings balance of \$278,401,000 as of June 30, 1998. While this represents a \$4,302,000 increase over FY 1997, the balance remains approximately 27.3 percent below the level at year-end FY 1992 when it peaked at \$383,148,000. Although retained earnings have decreased in four of the last five years, the overall asset-to-liability ratio for the 1943 Fund has remained nearly constant at approximately 108% during the same period. The excess of revenues over expenses for the Program for FY 1998 was \$4,302,000 compared to a deficiency of \$14,067,000 in FY 1997. The aggregate net deficiency of revenues for the Program during the five-year period reflected in the tables above was \$59,216,000.

As further described below, the Program has experienced significant losses during four of the last five years for three principal reasons: (i) a low interest rate environment that produced high prepayment levels and decreased investment earnings on bond proceeds and other invested funds in the 1943 Fund during FY 1994 through FY 1998; (ii) financial losses associated with the Department's self-insured life and disability and property insurance programs during FY 1994 through FY 1996; and (iii) losses on sale of repossessed properties and allowances for losses associated with the Department's portfolio of Contracts of Purchase during FY 1994 through FY 1998. However, as discussed below, over the last several years the Department has undertaken major initiatives to address each of these areas and expects such actions to have a positive impact on future years' financial performance.

The Program's FY 1998 net interest income (total interest income less bond interest expense) of \$20,723,000 was \$1,808,000 less than FY 1997. During the first four of the years represented in the table above net interest margin (net interest income divided by average interest bearing assets) improved, reflecting the Department's continuing efforts during the period to reduce debt service cost and increase interest income. These efforts have included, where possible, redemption of outstanding higher interest rate bonds prior to maturity and the transfer of certain invested funds from lower yielding variable rate instruments to higher yielding fixed rate investments. Notwithstanding these recent actions, the Department's net interest margin declined from 0.65% in FY 1997 to 0.60% in FY 1998 and will continue to be adversely affected in future years by the: (i) reduction of the interest rate on existing Contracts of Purchase from 8.00% to 6.95% implemented effective April 1, 1998 (see "PLAN OF FINANCE AND DEPARTMENT'S RECENT PROGRAMMATIC CHANGES—Department's Recent Programmatic Changes"); and (ii) \$814,440,000 (as of November 30, 1998) of outstanding Veterans G.O. Bonds issued in series without early redemption provisions, with average interest costs of approximately 9.00% and which cannot be fully retired before the year 2010 (see Exhibit E—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Veterans G.O. Bonds and Prior Revenue Bonds").

In addition to GASB 31 adjustments, net lending and financing activities income in FY 1998 was significantly impacted by several new factors. Such income was positively affected by a \$13,460,000 gain on the sale of certain securities in conjunction with the issuance of Revenue Bonds and Veterans General Obligation Bonds in 1997 and 1998 (the "1997/1998 Bonds"). Such income was negatively affected by amortizing \$3,068,000 of the financing and redemption costs relating to the issuance of the 1997/1998 Bonds and by premium costs of \$1,551,000 relating to the purchase of private mortgage insurance with respect to certain Contracts of Purchase—both of which are expected to represent recurring expenses for future years' operations.

Like all loan portfolios, the Program experienced fluctuating levels of prepayments and new originations of Contracts of Purchase primarily influenced by the rates of interest of conventional mortgage financing relative to the Program's interest rates (either 8.00% or 7.75% during the period reflected in the table above until March 31, 1998, and 6.95% thereafter). The net effect of these factors resulted in the outstanding principal balance of Contracts of Purchase declining 5.7% since June 30, 1994. (See Exhibit E—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA" for detailed information regarding the history of repayments, prepayments and originations of Contracts of Purchase.) During the first four years of such period, cash and invested funds dropped 28.5% due primarily to the use of such assets to pay bond maturities or redeem bonds and fund new Contracts of Purchase. During FY 1998, cash and investments increased by \$422,126,000 primarily as the result of issuance of the 1997/1998 Bonds which provided \$353 million of new funds to originate Contracts of Purchase. In aggregate, total Program assets have declined 7.8% since June 30, 1994. The debt structure of the Program, however, accommodated this downward trend in assets through a series of bond redemptions which resulted in a nearly equivalent reduction in the bonds outstanding. Other non-current assets increased by \$21,283,000 to \$36,406,000 at June 30, 1998 due primarily to the capitalization of financing and redemption costs relating to the 1997/1998 Bonds. Such non-income producing assets will be amortized over the term of the 1997/1998 Bonds and will have a negative effect on net income during such period.

Due to the decline in real estate values in certain California housing sub-markets in the early 1990's and the concentration of the Department's Contract of Purchase portfolio in certain areas of the State which were economically depressed due to military base closures and defense industry employment reductions, the number of repossessed properties ("REOs") and their loss on sale increased significantly between FY 1992 and FY 1997. However, the principal balance of Contracts of Purchase classified as REOs decreased \$12,166,000 from June 30, 1997 to June 30, 1998 compared to a \$42,738,000 cumulative increase over the preceding four-year period. Beginning in FY 1996, the Department moved aggressively to repossess properties of canceled Contracts of Purchase and dispose of its REOs. In conjunction with this effort, the Department reassessed the adequacy of its loss reserves and, over the four-year period FY 1994 to 1997, took cumulative net charges to its operating income of \$49,492,000 to provide for potential losses in the portfolio. During FY 1998, the incremental increase in the Department's loss allowance was reduced from \$22,677,000 in FY 1997 to \$1,312,000 in FY 1998 due to the adequacy of reserves funded in prior years and improvement in the overall performance of the Contracts of Purchase portfolio. As a result of actual losses realized in the disposition of REO properties and management of the Contracts of Purchase portfolio, accumulated loss reserves decreased \$9,407,000 during FY 1998. The remaining loss reserve of \$41,008,000 at June 30, 1998, together with the Department's (a) recent purchase of primary mortgage insurance with respect to more than \$780 million of existing Contracts of Purchase with high loan-to-value ratios; and (b) imposition of USDVA guaranties for substantially all new Contracts of Purchase originated beginning last year (see "THE PROGRAM—Loan Insurance"), are expected to provide for future potential REO losses.

Program administrative operating expenses in FY 1998 remained relatively flat after increasing 7.5% in FY 1997 due in large part to consulting expenses and personnel costs relating to identifying and developing strategies to: improve overall Program operations; procure a state-of-the-art integrated mortgage and finance computer system; and complete conversion of the life and disability insurance program to an outside commercial insurer. After taking into account a \$399,000 decrease in operating revenue, net administrative operating expenses increased 3.1% over FY 1997 results.

Effective June 1, 1996, the Department's self-insured life and disability coverage plan was transferred to a fully-insured plan underwritten by an outside commercial insurer except for that portion of the program covering existing claims of disabled Contract of Purchase holders for whom the Department continues to provide coverage. Loss reserves for these obligations have been actuarially determined. More than two-thirds of such loss reserves are funded and maintained under a third party administrator agreement. The remaining amount is unfunded, but reserved in the form of an accrued liability. The net effect of these changes resulted in the plan producing positive income in FY 1997 and FY 1998 compared to aggregate losses of \$36,373,000 over the four prior fiscal years.

Effective November 1, 1996, a number of changes were made to the Department's fire and hazard insurance coverage, including increasing the deductible, eliminating outdated loss coverages and limiting the claims period. These changes have resulted in stabilized financial operations for the Department's fire and hazard coverage over the last three fiscal years.

Further financial information relating to the 1943 Fund can be located in Exhibit A to this Official Statement.

## **THE OFFERED REVENUE BONDS**

### **General**

The Bonds will be dated, will bear interest at the rates and mature in the amounts and on the dates set forth on the inside front cover page of this Official Statement. Interest will be payable on the Offered 1999 Revenue Bonds semiannually on June 1 and December 1 of each year, commencing June 1, 1999. The 1997 Series C Bonds are subject to mandatory tender (with no right to retain), will be dated their date of original issuance, and will bear interest from their remarketing date at the rate, payable on June 1 and December 1 of each year, commencing June 1, 1999, and on their applicable Mandatory Tender Date, as set forth on the inside front cover page of this Official Statement. **This Official Statement is not intended to provide any information with respect to any 1997 Series C Bond after its applicable Mandatory Tender Date.** Interest on the Offered Revenue Bonds is calculated on the basis of a 360-day year consisting of twelve 30-day months.

Offered Revenue Bonds will be delivered in fully-registered form only and when delivered will be registered in the name of Cede & Co. as nominee of The Depository Trust Company, New York, New York ("DTC"). DTC will act as securities depository for the Offered Revenue Bonds. The Offered Revenue Bonds are issuable in book-entry form only in denominations of \$5,000 and any integral multiple thereof. See "BOOK-ENTRY ONLY SYSTEM."

### **Redemption of Offered 1999 Revenue Bonds**

#### ***Redemption from Mandatory Sinking Account Payments***

The 1999 Series A Bonds maturing December 1, 2019 (the "1999A 2019 Term Bonds"), the 1999 Series A Bonds maturing December 1, 2027 (the "1999A 2027 Term Bonds"), the 1999 Series B Bonds maturing on December 1, 2019 (the "1999B 2019 Term Bonds"), and 1999 Series B Bonds maturing December 1, 2028 (the "1999B 2028 Term Bonds") are subject to mandatory redemption prior to their respective stated maturities, in part, by lot, at a redemption price equal to 100% of the principal amount thereof plus accrued interest to the date fixed for redemption, without premium, from Mandatory Sinking Account Payments, on the respective dates and in the respective amounts set forth in Exhibit C—"MANDATORY SINKING ACCOUNT PAYMENTS."



Pursuant to the Resolution, if less than all of the Term Bonds of a maturity of the Offered 1999 Revenue Bonds are purchased or called for redemption (other than in satisfaction of Mandatory Sinking Account Payments), the Trustee will credit the principal amount of such Term Bonds that are so purchased or redeemed against applicable remaining Mandatory Sinking Account Payments (including the principal amounts due on the respective maturity dates, as shown above) as directed by the Department or, if no direction is given, then against all applicable remaining Mandatory Sinking Account Payments in the proportion that the then-remaining balance of each such Mandatory Sinking Account Payment (including the principal amount due on the respective maturity date, as shown above) bears to the total of all applicable Mandatory Sinking Account Payments (including the principal amounts due on the respective maturity date, as shown above).

### ***Optional Redemption***

The Offered 1999 Revenue Bonds are subject to redemption at any time on or after June 1, 2004, at the option of the Department, and from any source of available funds, as a whole or in part by such maturity or maturities of a Series, and such amounts within each such maturity, as may be selected by the Department in its sole discretion (and by lot within a maturity of a series), at redemption prices equal to the following amounts (expressed as percentages of the principal amount of the Offered 1999 Revenue Bonds or portion thereof to be redeemed) plus accrued interest to the date fixed for redemption, as follows:

<b><u>Redemption Period</u></b> <b><u>(both dates inclusive)</u></b>	<b><u>Redemption</u></b> <b><u>Price</u></b>
June 1, 2004 to May 31, 2005.....	101%
June 1, 2005 and thereafter .....	100%

### ***Special Redemption from Unexpended Proceeds and Excess Revenues***

The Offered 1999 Revenue Bonds are subject to redemption at the option of the Department in whole or in part at any time, at a redemption price equal to 100% of the principal amount thereof plus interest accrued thereon to the date fixed for redemption in an amount equal to (i) moneys deposited in the Revenue Bond Series Proceeds Subaccount with respect to the Offered 1999 Revenue Bonds on the date of issuance of the Offered 1999 Revenue Bonds that have not been applied to finance Contracts of Purchase, and (ii) Excess Revenues. The Offered 1999 Revenue Bonds to be so redeemed shall be such maturities of such Series, and such amounts within a maturity, as shall be selected by the Department.

Although the Department's goal is to use moneys made available through the issuance of the Offered 1999 Revenue Bonds (including recycled prepayments) to finance Contracts of Purchase for veterans who do not qualify under the Federal Tax Code for other sources of Department funding, such expectation is subject to change, and such moneys or prepayments would then be available to redeem Revenue Bonds and Veterans G.O. Bonds.

Excess Revenues (defined in "SUMMARY OF CERTAIN PROVISIONS OF THE RESOLUTION—Definitions (Section 103)") can include prepayments and repayments on Contracts of Purchase funded by both Revenue Bonds (including Prior Revenue Bonds and Additional Revenue Bonds) and Veterans G.O. Bonds, and also include Revenues which had been set aside to be recycled into new Contracts of Purchase. See "THE OFFERED REVENUE BONDS—Redemption—Information Regarding Prepayments" for additional information regarding prepayments of Contracts of Purchase.

Additional moneys may become available to finance Contracts of Purchase through the future issuances of Revenue Bonds and Veterans G.O. Bonds. The Department, subject to the applicable authorizing resolutions, has full discretion to use moneys available from prior, current or future

bond issues to finance Contracts of Purchase in any order of priority it chooses. See Exhibit E—"CERTAIN DEPARTMENT INFORMATION AND OPERATING DATA—Contracts of Purchase—Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments."

### ***Information Regarding Prepayments***

The Department's actual past prepayment experience for existing Contracts of Purchase is set forth in Exhibit E—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Contracts of Purchase—Existing Contracts of Purchase Origination and Principal Repayment Experience." However, since the Department has substantially reduced the interest rates on all existing Contracts of Purchase, the prepayment experience reflected in the chart may not predict the future behavior of such Contracts of Purchase after the interest rate reduction.

For certain Revenue Bonds issued or to be issued after 1988 (not including the Offered 1999 Revenue Bonds), the Internal Revenue Code of 1986, as amended (the "Federal Tax Code"), permits repayments (including prepayments) of principal of Contracts of Purchase financed with the proceeds of an issue of such bonds to be used to make additional Contracts of Purchase for only 10 years from the date of issuance of such bonds (or the date of issuance of original bonds in the case of refundings), after which date such amounts must be used to redeem such bonds of the issue, except for a \$250,000 de minimis amount.

The Federal Tax Code requires a payment to the United States from certain veterans whose Contracts of Purchase are originated after December 31, 1990 with the proceeds of certain Revenue Bonds (not including the Offered 1999 Revenue Bonds). See "TAX MATTERS—Federal Tax Matters—Other Requirements Imposed by the Federal Tax Code—Recapture Provision." Since such requirement remains in effect with respect to any Contracts of Purchase originated after December 31, 1990 with proceeds of certain Revenue Bonds, for a period ending nine years after the execution of such Contracts of Purchase, the Department is unable to predict what effect, if any, such requirement will have on the origination or prepayment of Contracts of Purchase to which such provision applies.

## **Redemption and Mandatory Tender of 1997 Series C Bonds**

### ***Optional Redemption***

The 1997 Series C Bonds are subject to redemption on their Mandatory Tender Date or any date which could be designated a Mandatory Tender Date, at the option of the Department, and from any source of available funds, including unexpended proceeds and Excess Revenues, as a whole or in part at a redemption price equal to the principal amount thereof, together with accrued interest to the redemption date.

### ***Mandatory Tender***

Each 1997 Series C Bond will be subject to mandatory tender (with no right to retain) on its Mandatory Tender Date at a purchase price equal to 100% of the principal amount thereof. "Mandatory Tender Date" means each date on which the 1997 Series C Bonds or any portion thereof are subject to adjustment to a new rate or rates of interest, which date is December 1, 2001, unless the Department designates one or more business days prior thereto on or after August 1, 2000 as the Mandatory Tender Date for all or a portion of the 1997 Series C Bonds. References to "its Mandatory Tender Date" or "the applicable Mandatory Tender Date" with respect to a 1997 Series C Bond shall mean the date on which the interest rate on such Bond is adjusted to a new

rate of interest. ***This Official Statement is not intended to provide any information with respect to any 1997 Series C Bond after its applicable Mandatory Tender Date.*** Payment of the purchase price of 1997 Series C Bonds will be made to the holders thereof upon surrender of their 1997 Series C Bonds. In the event of a failure to remarket all or a portion of such 1997 Series C Bonds subject to mandatory tender on a Mandatory Tender Date, such unremarketed 1997 Series C Bonds will be purchased or redeemed by the Trustee (without further notice to the holders) with moneys available for such purpose and will be canceled and retired by the Trustee.

If the Department designates the Mandatory Tender Date for all or any portion of the 1997 Series C Bonds to be a date other than December 1, 2001, then no later than the 30th day prior to such earlier Mandatory Tender Date (the "Notification Date"), the Trustee will send written notice by first class mail, postage prepaid, to each holder of a 1997 Series C Bond for which such date is its Mandatory Tender Date, stating (i) the Mandatory Tender Date, (ii) that such 1997 Series C Bond will be deemed to be tendered for purchase on such Mandatory Tender Date at a purchase price equal to 100% of the principal amount thereof, (iii) that such 1997 Series C Bond will be purchased or redeemed without further notice on the Mandatory Tender Date, and (iv) that the purchase price or redemption price of each 1997 Series C Bond will be payable by the Trustee upon delivery to the Trustee of such 1997 Series C Bond. So long as all of the 1997 Series C Bonds for which such date is a Mandatory Tender Date are immobilized in the custody of DTC, such notice will be delivered by the Trustee to DTC or its nominee as holder of such 1997 Series C Bonds. DTC is responsible for notifying Participants, and Participants and Indirect Participants are responsible for notifying Beneficial Owners. Neither the Trustee nor the Department is responsible for sending notices to Beneficial Owners or for the consequences of any action or inaction by the Department as a result of the response or failure to respond by DTC or its nominee as holder.

#### **General Provisions as to Redemption**

The Resolution permits the purchase of Offered Revenue Bonds at public or private sales by the Department or the Trustee. Any Offered Revenue Bonds so purchased may be credited against any redemption amounts.

The Resolution provides that whenever Offered Revenue Bonds may be redeemed in part within a maturity of a Series the Trustee will select the Offered Revenue Bonds to be redeemed by lot in any manner which the Trustee in its sole discretion may determine. However, see "BOOK-ENTRY ONLY SYSTEM" for a description of DTC's practices regarding selection of beneficial ownership interests in bonds for redemption.

Notice of redemption of any Offered Revenue Bonds to be redeemed will be given by the Trustee for and on behalf of the Department. Each notice of redemption will state the redemption date, the place or places of redemption, the redemption price, if any, the CUSIP number (if any) of the maturity or maturities, and, if less than all of any such maturity is to be redeemed, such other additional information as is described in the Resolution. No further interest will accrue on the principal of any Offered Revenue Bonds called for redemption after the redemption date. Notice of redemption will be mailed, not less than fifteen nor more than ninety days prior to the redemption date, to the respective registered owners of any Offered Revenue Bonds designated for redemption at their addresses appearing on the registration books of the Trustee. Notice of redemption will also be provided by mail to certain financial services as provided in the Resolution. No defect in the notice of redemption or mailing thereof (including any failure to mail such notice) to any Bondowner will affect the validity of the redemption proceedings for any other Offered Revenue Bonds.

## **BOOK-ENTRY ONLY SYSTEM**

**THE INFORMATION CONCERNING DTC AND DTC'S BOOK-ENTRY SYSTEM HAS BEEN OBTAINED FROM DTC, AND NEITHER THE DEPARTMENT NOR THE UNDERWRITERS TAKE RESPONSIBILITY FOR THE ACCURACY OR COMPLETENESS THEREOF.**

The following description of the procedures and recordkeeping regarding the beneficial ownership interests in the Offered Revenue Bonds, payment of principal, premium, if any, interest, and purchase price with respect to the Offered Revenue Bonds to DTC, the Participants or Beneficial Owners, confirmation and transfers of beneficial ownership interests in the Offered Revenue Bonds and other related transactions by and between DTC, the Participants and the Beneficial Owners is based on information provided by DTC. Accordingly, no representations can be made concerning these matters. The Beneficial Owners should not rely on the following information with respect to such matters, but should instead confirm the same with the applicable Participants.

DTC, located in New York, New York, will act as securities depository for the Offered Revenue Bonds. The Offered Revenue Bonds will be issued as fully-registered securities registered in the name of Cede & Co. (DTC's partnership nominee) ("Cede"). One fully-registered bond certificate will be issued for each of the maturities of each Series of the Offered Revenue Bonds, each in the aggregate principal amount of such maturity, and will be deposited with DTC.

DTC is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934, as amended. DTC holds securities that its participants ("Participants") deposit with DTC. DTC also facilitates the settlement among Participants of securities transactions, such as transfers and pledges, in deposited securities through electronic computerized book-entry changes in Participants' accounts, thereby eliminating the need for physical movement of securities certificates. Direct Participants include securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is owned by a number of its Direct Participants and by the New York Stock Exchange, Inc., the American Stock Exchange, Inc., and the National Association of Securities Dealers, Inc. Access to the DTC system is also available to others such as securities brokers and dealers, banks, and trust companies that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly ("Indirect Participants"). The Rules applicable to DTC and its Participants are on file with the Securities and Exchange Commission.

Purchases of Offered Revenue Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the Offered Revenue Bonds on DTC's records. The ownership interest of each actual purchaser of each Offered Revenue Bond ("Beneficial Owner") is in turn to be recorded on the Direct and Indirect Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchase, but Beneficial Owners are expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Offered Revenue Bonds are to be accomplished by entries made on the books of Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in Offered Revenue Bonds, except in the event that use of the book-entry system for the Offered Revenue Bonds is discontinued.

To facilitate subsequent transfers, all Offered Revenue Bonds deposited by Participants with DTC are registered in the name of DTC's partnership nominee, Cede. The deposit of Offered

Revenue Bonds with DTC and their registration in the name of Cede effect no change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Offered Revenue Bonds; DTC's records reflect only the identity of the Direct Participants to whose accounts such Offered Revenue Bonds are credited, which may or may not be the Beneficial Owners. The Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Participants, by Participants to Indirect Participants, and by Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them subject to any statutory or regulatory requirements as may be in effect from time to time.

Redemption notices shall be sent to Cede. If less than all of a maturity of a Series of the Offered Revenue Bonds is being redeemed or remarketed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in such maturity to be redeemed or remarketed.

Neither DTC nor Cede will consent or vote with respect to Offered Revenue Bonds. Under its usual procedures, DTC mails an Omnibus Proxy to the Department as soon as possible after the record date. The Omnibus Proxy assigns Cede's consenting or voting rights to those Direct Participants to whose accounts the Offered Revenue Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Payments of principal and purchase price of and interest on the Offered Revenue Bonds will be made to DTC. DTC's practice is to credit Direct Participants' accounts on a payment date in accordance with their respective holdings shown on DTC's records, unless DTC has reason to believe that it will not receive payment on such payment date. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC, the Trustee, or the Department, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal, purchase price and interest to DTC is the responsibility of the Trustee or the Department, disbursement of such payments to Direct Participants shall be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners shall be the responsibility of Direct and Indirect Participants. **NEITHER THE DEPARTMENT NOR THE TRUSTEE WILL HAVE ANY RESPONSIBILITY OR OBLIGATION TO SUCH PARTICIPANTS, TO THE PERSONS FOR WHOM THEY ACT AS NOMINEES WITH RESPECT TO THE OFFERED REVENUE BONDS, OR TO ANY BENEFICIAL OWNER IN RESPECT OF THE ACCURACY OF ANY RECORDS MAINTAINED BY DTC OR ANY DIRECT OR INDIRECT PARTICIPANT, THE PAYMENT BY DTC OR ANY DIRECT OR INDIRECT PARTICIPANT OF ANY AMOUNT IN RESPECT OF THE PRINCIPAL, PURCHASE PRICE OR REDEMPTION PRICE OF OR INTEREST ON THE OFFERED REVENUE BONDS, ANY NOTICE THAT IS PERMITTED OR REQUIRED TO BE GIVEN TO BONDOWNERS UNDER THE RESOLUTION, THE SELECTION BY DTC OR ANY DIRECT OR INDIRECT PARTICIPANT OF ANY PERSON TO RECEIVE PAYMENT IN THE EVENT OF A PARTIAL REDEMPTION OR REMARKETING OF THE OFFERED REVENUE BONDS, OR ANY OTHER ACTION TAKEN BY DTC AS REGISTERED BONDOWNER.**

**THE TRUSTEE, AS LONG AS THE DTC BOOK-ENTRY METHOD IS USED FOR THE OFFERED REVENUE BONDS, WILL SEND ANY NOTICE OF PREPAYMENT OR OTHER NOTICES ONLY TO DTC OR ITS NOMINEE. ANY FAILURE OF DTC TO ADVISE ANY PARTICIPANT, OR THE FAILURE OF ANY PARTICIPANT TO NOTIFY ANY BENEFICIAL OWNER, OF ANY SUCH NOTICE AND ITS CONTENT OR EFFECT WILL**

**NOT AFFECT THE VALIDITY OR SUFFICIENCY OF THE PROCEEDINGS RELATING TO THE PREPAYMENT OF THE OFFERED REVENUE BONDS CALLED FOR PREPAYMENT OR OF ANY OTHER ACTION PREMISED ON SUCH NOTICE.**

Conveyance of notices and other communications by DTC to the Participants, by the Participants to Indirect Participants, and by the Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory and regulatory requirements as may be in effect from time to time.

So long as the DTC book-entry method is used for the Offered Revenue Bonds, payments of principal, purchase price, premium, if any, and interest with respect to the Offered Revenue Bonds will be made by the Trustee only to DTC or its nominee as the registered owner of the Offered Revenue Bonds, and all such payments shall be valid and effective to fully satisfy and discharge the Department's obligations with respect to the principal, purchase price, premium, if any, and interest with respect to the Offered Revenue Bonds to the extent of the sum or sums so paid. Transfer or crediting of the applicable principal, purchase price, premium, if any, and interest payments to its Participants is the responsibility of DTC, and to Beneficial Owners or their nominees is the responsibility of the Participants.

**THE DEPARTMENT AND THE TRUSTEE CANNOT AND DO NOT GIVE ANY ASSURANCES THAT DTC, PARTICIPANTS OR OTHERS WILL DISTRIBUTE PAYMENTS WITH RESPECT TO THE OFFERED REVENUE BONDS RECEIVED BY DTC OR ITS NOMINEE AS THE REGISTERED OWNER, OR ANY PREPAYMENT OR OTHER NOTICES, TO THE BENEFICIAL OWNERS, OR THAT THEY WILL DO SO ON A TIMELY BASIS, OR THAT DTC WILL SERVICE AND ACT IN THE MANNER DESCRIBED IN THIS OFFICIAL STATEMENT.**

The Department and the Trustee understand that the current "Rules" applicable to DTC are on file with the Securities and Exchange Commission, and that the current "Procedures" of DTC to be followed in dealing with Participants are on file with DTC.

The Department and the Trustee may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depository). In that event, Offered Revenue Bond certificates will be printed and delivered. DTC may discontinue providing its services as securities depository with respect to the Offered Revenue Bonds at any time by giving reasonable notice to the Trustee. Under such circumstances, in the event that a successor securities depository is not obtained, Offered Revenue Bond certificates are required to be printed and delivered. In the event the Department and the Trustee determine not to continue the DTC book-entry only system or DTC determines to discontinue providing its services with respect to the Offered Revenue Bonds and the Department and the Trustee do not select another qualified securities depository, the Trustee shall deliver one or more Offered Revenue Bonds in such principal amount or amounts, in the denominations of \$5,000 or any integral multiple thereof, and Offered Revenue Bonds may be transferred upon the books of the Trustee by the registered owners, in person or by authorized attorney, upon surrender of the Offered Revenue Bonds at the office of the Trustee, accompanied by delivery of an executed instrument of transfer in a form approved by the Trustee and upon payment of any charges provided for in the Resolution, and the Offered Revenue Bonds may be exchanged for Offered Revenue Bonds of other authorized denominations of the same aggregate principal amount, series and maturity at the office of the Trustee, upon payment of any charges provided for in the Resolution. No transfer or exchange of the Offered Revenue Bonds shall be made by the Trustee during the 15 days next preceding each interest payment date.

**DTC's Year 2000 Efforts**

DTC management is aware that some computer applications, systems, and the like for processing data ("Systems") that are dependent upon calendar dates, including dates before, on, and

after January 1, 2000, may encounter "Year 2000 problems." DTC has informed its Participants and other members of the financial community (the "Industry") that it has developed and is implementing a program so that its Systems, as the same relate to the timely payment of distributions (including principal and income payments) to security holders, book-entry deliveries, and settlement of trades within DTC ("DTC Services"), continue to function appropriately. This program includes a technical assessment and a remediation plan, each of which is complete. Additionally, DTC's plan includes a testing phase, which is expected to be completed within appropriate time frames.

However, DTC's ability to perform properly its services is also dependent upon other parties, including but not limited to issuers and their agents, as well as third party vendors from whom DTC licenses software and hardware, and third party vendors on whom DTC relies for information or the provision of services, including telecommunication and electrical utility service providers, among others. DTC has informed the Industry that is its contacting (and will continue to contact) third party vendors from whom DTC acquires services to: (i) impress upon them the importance of such services being Year 2000 compliant; and (ii) determine the extent of their efforts for Year 2000 remediation (and, as appropriate, testing) of their services. In addition, DTC is in the process of developing such contingency plans as it deems appropriate.

According to DTC, the foregoing information with respect to DTC has been provided to the Industry for informational purposes only and is not intended to serve as a representation, warranty, or contract modification of any kind.

## **ESTIMATED APPLICATION OF OFFERED REVENUE BOND PROCEEDS**

### **Offered 1999 Revenue Bonds**

The sources of funds and the uses thereof in connection with the Offered 1999 Revenue Bonds, exclusive of accrued interest thereon, after expected transfers and exchanges, are expected to be approximately as set forth below.

	<b>1999 Series A Bonds</b>	<b>1999 Series B Bonds</b>
<b>SOURCES</b>		
Offered 1999 Revenue Bond proceeds	\$54,170,000.00	\$86,085,000.00
Original Issue Discount	(170,550.00)	(274,668.75)
Available amounts in the 1943 Fund	5,229,539.06	8,739,120.52
	<u>\$59,228,989.06</u>	<u>\$94,549,451.77</u>
<b>USES</b>		
Payment of Refunded Bonds	\$53,999,450.00	\$85,810,331.25
Deposit to 1999 A/B Revenue Bond Series		
Proceeds Subaccount <sup>(1)(2)</sup>	886,955.63	1,838,044.37
Deposit to Bond Reserve Account <sup>(1)</sup>	3,791,900.00	6,025,950.00
Costs of issuance	121,144.37	192,518.24
Underwriters' compensation	429,539.06	682,607.91
	<u>\$59,228,989.06</u>	<u>\$94,549,451.77</u>

<sup>(1)</sup> Following certain allocations for federal tax purposes.

<sup>(2)</sup> On or about the date of issuance of the 1999 Series B Bonds, an additional amount of approximately \$100,000,000 will be made available to finance Contracts of Purchase. See Exhibit E—"Certain Department Information and Operating Data—Contracts of Purchase—Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments."

### **1997 Series C Bonds**

Proceeds of the 1997 Series C Bonds were deposited in the 1997 C Revenue Bond Series Proceeds Subaccount at the time of issuance of the 1997 Series C Bonds. Such proceeds will become available to finance Contracts of Purchase or for deposit in the Bond Reserve Account only in amounts proportionate to the principal amount of 1997 Series C Bonds which convert to bear interest at fixed rates to maturity. The costs of remarketing of the 1997 Series C Bonds will be paid with available moneys of the Department. Moneys received from the new purchasers of 1997 Series C Bonds on their remarketing date will be used to pay the purchase price of tendered 1997 Series C Bonds to tendering Bondowners.

## **THE PROGRAM**

### **General**

The Department began making low interest rate farm and home financing available to veterans after World War I, following the enactment by the California Legislature ("Legislature") of the Veterans Farm and Home Purchase Act of 1921. In 1943, the Legislature enacted the Veterans Farm and Home Purchase Act of 1943 ("1943 Act") which modified the Program to meet new needs of veterans. The 1943 Act was superseded by the Veterans Farm and Home Purchase Act of 1974 ("1974 Act") which again modified the Program. The 1943 Act established the 1943 Fund in the State Treasury, which is the principal fund utilized by the Program.

Since its inception, the Program has assisted over 405,000 veterans to purchase farms and homes throughout the State through long-term housing and farm loans. The sales of revenue bonds and Veterans G.O. Bonds, combined with surplus revenues from borrowers under the Program not needed at any given time to meet the then-current bond retirement schedules and operating costs, have financed the purchase of farms and homes since Program inception. As of November 30, 1998 there were 34,847 Contracts of Purchase outstanding with a remaining principal balance of \$2,071,536,000. See Exhibit E—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Contracts of Purchase—Existing Contracts of Purchase" and "—Amounts Expected to be Available to Finance Contracts of Purchase and Related Investments" for information regarding existing Contracts of Purchase and moneys available to finance additional Contracts of Purchase.

The description of the Program under this heading is a description of the Program as it currently exists under the Veterans Code and the Department's implementation thereof, including recent programmatic changes. The Veterans Code and the Department's implementation thereof are subject to change. The Program is also subject to the Federal Tax Code, as noted below.

### **Qualifying Veteran Status**

**Veterans Code.** A veteran must meet qualifications established under State law in the Veterans Code in order to participate in the Program. The qualifications specified in the Veterans Code are subject to change by the Legislature. The Veterans Code currently requires, generally, that a veteran must have served at least ninety days on active duty in the Armed Forces of the United States, unless sooner discharged because of a service-connected disability, or as a member of the National Guard or reserves called to active duty by Presidential order, and must have received an honorable discharge or been released from active duty under honorable conditions. The Veterans Code (including amendments effective January 1, 1998) allows the Department to finance Contracts of Purchase for:

- (a) veterans who have served during a period which includes service in one of the following periods:



(i) April 6, 1917 through November 11, 1918; December 7, 1941 through December 31, 1946; or June 27, 1950 through January 31, 1955 (such veterans are referred to as "Earlier War Veterans");

(ii) February 28, 1961 through August 4, 1964 if the veteran served in the Republic of Vietnam during that period ("Early Vietnam Veterans"); or August 5, 1964 through May 7, 1975 (all veterans referred to in this clause (ii) are "Vietnam Era Veterans"); or

(iii) on or after August 2, 1990, through a date as yet to be determined by the President of the United States; at any time in Somalia, or in direct support of the troops in Somalia, during Operation Restore Hope; or at any time in an expedition or campaign for which a medal was authorized by the United States Government such as the Armed Forces Expeditionary and Vietnam Service Medals (such veterans are referred to as "Recent War Veterans"); and

(b) any person who qualifies under the Federal Tax Code for financing from revenue bonds or unrestricted funds of the Department and who served in the active military, naval, or air service for a period of not less than 90 consecutive days and who received an honorable discharge or was released from active duty under honorable conditions (such veterans are referred to as "Peacetime Veterans").

The amendments to the Veterans Code effective January 1, 1998 added Early Vietnam Veterans and Peacetime Veterans as veterans eligible to receive Contracts of Purchase. The Department expects these amendments to significantly increase the universe of potential contract holders, and to increase demand for Contracts of Purchase.

**Federal Tax Code.** In order to determine which Department moneys can be used to finance Contracts of Purchase, the Department must also take into account the requirements of federal law set forth in the Federal Tax Code, which limits the universe of veterans eligible to receive Contracts of Purchase financed from certain sources. Applying the current Federal Tax Code separates the Department's lendable moneys into three classes:

(a) "Unrestricted Moneys" (derived from certain moneys in the 1943 Fund and certain proceeds of pre-Ullman revenue bonds and veterans general obligation bonds, including certain future issues of taxable bonds, if any), which can finance Contracts of Purchase for those veterans who qualify under the applicable provisions of the Veterans Code (there are no loan eligibility requirements imposed by the Federal Tax Code with respect to Contracts of Purchase financed by Unrestricted Moneys; these are requirements principally limiting the family income of applicants and the property purchase price, and, subject to certain exceptions, requiring that the veteran not have had a present ownership interest in his principal residence in the three years prior to obtaining such financing ("QMB Loan Eligibility Requirements")). The Department has implemented a policy (which is subject to change) to make such moneys available for Earlier War Veterans, Vietnam Era Veterans, and Recent War Veterans. ("Pre-Ullman" refers to the period prior to enactment of Federal Tax Code restrictions on the use of proceeds of tax-exempt bonds to finance mortgage loans.)

(b) "Qualified Veterans Mortgage Bond Proceeds" (derived exclusively from proceeds of Veterans G.O. Bonds) which can finance Contracts of Purchase for any veteran who (i) qualifies under the Veterans Code, (ii) served on active duty prior to January 1, 1977, and (iii) was released from active duty fewer than 30 years before receiving such financing. The last date of veteran eligibility under clause (iii) is December 31, 2036 for a veteran with 30 years of continuous service after December 31, 1976. (The QMB Loan Eligibility Requirements do not apply to Contracts of Purchase financed by such moneys.) These proceeds can finance Contracts of Purchase for Earlier War Veterans and Vietnam Era Veterans; and

(c) "Qualified Mortgage Bond Proceeds" (which are principally derived from Revenue Bond proceeds), can finance Contracts of Purchase for any veteran who (i) qualifies under the Veterans Code, and (ii) satisfies the QMB Loan Eligibility Requirements. These proceeds can finance Contracts of Purchase for Earlier War Veterans, Vietnam Era Veterans, Recent War Veterans, and Peacetime Veterans.

### **Allocation of Lendable Moneys**

For those veterans seeking financing who would qualify for Contracts of Purchase from two or more of the above-described financing sources, the Department will select the source of funds to use in its sole discretion. The Department's goal is to maximize the availability of Program benefits. The Board has approved a policy (which is subject to change) to make Qualified Mortgage Bond Proceeds derived from Revenue Bonds the only financing source for Contracts of Purchase for veterans who did not serve during "wartime" (as defined in the Veterans Code).

### **Administration of the Farm and Home Purchase Program**

The Department finances new and existing single-family homes, farms and mobile homes located in the State by acquiring the property selected by a veteran under a Contract of Purchase. The Department also finances home improvements with respect to properties covered by existing Contracts of Purchase, subject to applicable restrictions of the Federal Tax Code. A Contract of Purchase creates an installment land contract between the Department and the veteran which is analogous to a loan from the Department to the veteran. The amount which the Department finances is reflected in the Contract of Purchase as the "purchase price."

At present under the Veterans Code, the maximum purchase price to the Department of an existing home or the sum to be expended by the Department pursuant to a Contract of Purchase for a home to be constructed is \$250,000 and for farms is \$300,000 (except that the limitation with respect to certain mobile homes in mobile home parks is \$70,000 and except that the maximum purchase price for any home may be increased by an additional \$5,000 for certain purposes). The Legislature has periodically made changes in the maximum amount that may be financed under a Contract of Purchase. The Federal Tax Code imposes maximum purchase prices on properties which are the subject of Contracts of Purchase financed by Qualified Mortgage Bond Proceeds, which maximums are adjusted periodically. (No Federal Tax Code purchase price limits apply to Contracts of Purchase financed from Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds). These Federal Tax Code requirements vary depending upon where the property is located, if it is in a targeted or non-targeted area, and whether it is a new or existing home. These Federal Tax Code limits currently range from \$88,266 to \$313,512. The maximum purchase price under the Program is, therefore, the Veterans Code maximum amount or, if the Contract of Purchase is being financed by Qualified Mortgage Bond Proceeds, the lesser of the Veterans Code maximum amount or the maximum amount under applicable provisions of the Federal Tax Code.

Although the Veterans Code does not impose maximum income limits, the Federal Tax Code imposes maximum income limits applicable only to veterans obtaining Contracts of Purchase financed by Qualified Mortgage Bond Proceeds. The income limits vary by statistical area and family size. No maximum income limits apply to veterans obtaining Contracts of Purchase financed by Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds.

Under amendments to the Veterans Code effective January 1, 1998, any veteran who qualifies under the Veterans Code and the Federal Tax Code may be granted a subsequent Contract of Purchase so long as any previous Contract of Purchase has been paid in full or the veteran lost his interest in the previous Contract of Purchase through divorce or dissolution of marriage.

## **Contracts of Purchase**

**General.** Pursuant to the Program, the Department and the veteran enter into a Contract of Purchase for a farm, home or mobile home. Under a Contract of Purchase, the veteran has the benefits of ownership as the equitable owner, but title to the property and improvements is held by the Department as the legal owner until the final principal payment is made. Property sold under a Contract of Purchase may not be transferred, assigned, encumbered, leased, let or sublet without the written consent of the Department. Any permitted encumbrance must be junior or secondary to the Department's interest in the property.

In the past, Contracts of Purchase were not insured or guarantied by the Federal Housing Administration, the USDVA, Rural Development (formerly, Farmers' Home Administration), or any private primary mortgage insurer. Now that the Department has been approved by the USDVA as an originator of loans eligible to receive a guaranty from the USDVA, USDVA guaranties are expected to be obtained for most new high loan-to-value ("LTV") Contracts of Purchase. In addition to the USDVA guaranty, the Department has secured primary mortgage insurance for a pool of certain Contracts of Purchase with LTV ratios above 80%, but not to exceed 97%, from Commonwealth Mortgage Assurance Company ("CMAC"). This insurance retroactively covers, effective February 1, 1998, aggregate losses incurred above a 2% deductible. Veterans and properties which are not USDVA eligible and which do not meet CMAC eligibility criteria are expected to continue to be the subject of the Department's Self Insurance Mortgage Loss Set-Aside account (described below). Any change to the foregoing insurance and guaranty expectations would require amending the Department's Program Operating Procedures and delivering a new Cash Flow Statement.

The terms of the Contracts of Purchase are substantially identical regardless of whether they are funded by Unrestricted Moneys, Qualified Veterans Mortgage Bond Proceeds or Qualified Mortgage Bond Proceeds, except for Federal Tax Code-mandated differences in Contracts of Purchase financed with Qualified Mortgage Bond Proceeds. Two ways in which such Contracts of Purchase are different are: (a) Contracts of Purchase financed by Qualified Mortgage Bond Proceeds have more restrictions on the right of a purchaser to assume the obligations under the Contract of Purchase than do Contracts of Purchase financed by Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds; and (b) certain Contracts of Purchase financed by Qualified Mortgage Bond Proceeds are subject to recapture provisions. In addition, the Federal Tax Code contains numerous loan eligibility restrictions on borrowers receiving financing from proceeds such as Qualified Mortgage Bond Proceeds. These restrictions require, among other things, and subject to certain exceptions contained in the Federal Tax Code, that borrowers (i) not have had a present ownership interest in their principal residence during the three-year period preceding the extension of financing, (ii) are eligible to finance the purchase of residences with purchase prices not in excess of limits stated in the Federal Tax Code, (iii) must not have family incomes in excess of limits stated in the Federal Tax Code, (iv) may not use the proceeds of the financing to refinance an existing mortgage loan and (v) may use the proceeds of the financing only to finance one-family or one-to-four family dwelling units meeting certain criteria. The Federal Tax Code includes certain procedures that an issuer of Qualified Mortgage Bonds may undertake to satisfy these requirements but requires that 95% or more of the proceeds of the issue be used in full compliance with the loan eligibility restrictions.

Since the number and value of Contracts of Purchase relating to farms and mobile homes, and Contracts of Purchase financed pursuant to the 1943 Act are statistically insignificant, the discussion below is limited to Contracts of Purchase financed under the 1974 Act for homes, excluding farms and mobile homes in rental parks, unless otherwise indicated. See Exhibit E—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Contracts of Purchase—Existing Contracts of Purchase."

**Origination.** The Veterans Code, in most cases, requires the veteran to make an initial payment of 2% of either the purchase price or the market value of the property, whichever is less. The balance of the purchase price, including USDVA guaranty fees, may be amortized over a period fixed by the Department, not exceeding 30 years and 32 days for all Contracts of Purchase guaranteed by USDVA, and 40 years of any other Contracts of Purchase. Department policy is to issue all new Contracts of Purchase for terms of 30 years. Existing contracts are occasionally extended beyond 30 years in cases of extreme financial hardship.

A Loan Origination Fee ("LOF") of 1% is collected at close of escrow on all contracts issued after January 1, 1999. This fee must be paid in escrow by the buyer or seller. If the loan application is submitted through an approved mortgage broker, the 1% fee is paid directly to the broker through the escrow. Otherwise, the fee is retained by the Department. While the Department's field offices will continue to originate Contracts of Purchase, the Department expects the bulk of the Contracts of Purchase to be originated by mortgage loan brokers in the future. The brokers will deal directly with the central underwriting, escrow and administrative staff in Sacramento, not through the Department's field offices. An appraisal fee of \$300 to \$425 is collected from the applicant and is paid directly to the appraiser upon completion of the assignment. In rare cases, where the appraisal is performed by a Department employee, the fee is retained by the Department.

The Veterans Code permits the Department to finance permanent home and property improvements for veterans with existing Contracts of Purchase. Total financing, including the balance of the original loan, the amount of the improvement loan, and any other encumbrances, cannot exceed 90% of the improved market value of the property. Typically this total LTV ratio is much lower than 90%. Improvement loans are not approved for veterans who have had significant delinquencies in the 12 months immediately preceding the application. Funds are disbursed by the Department directly to the contractors (or vendors) as the improvements are completed. A separate Contract of Purchase is executed which bears interest at the same rate as the existing contract. The new Contract of Purchase is payable over a term up to 15 years based on the amount of the Contract of Purchase. In no event can the term, from the inception of the original Contract of Purchase through the pay-off of the improvement Contract of Purchase, exceed 40 years. A LOF of 1.5% of the improvement Contract of Purchase amount is charged. The maximum home improvement loan for veterans funded with Qualified Mortgage Bond Proceeds is \$15,000 over the term of the original Contract of Purchase. Home improvement loans funded with Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds are available up to a maximum of \$50,000. Subsequent home improvement Contracts of Purchase may be granted, if funds are available, so long as there is only one home improvement Contract of Purchase to any veteran outstanding at any time.

Contracts of Purchase for the purchase of a building site and construction of a home are available. Qualifying sites include undeveloped sites/acreage, lots in subdivision developments, and sites in non-profit self help developments. Mobile homes in parks do not qualify. Construction of the improvements must be performed by a licensed California contractor. The Department does not submit Contracts of Purchase which finance home construction for USDVA guaranty during the construction phase. Procedures are being developed to obtain guaranties on the properties once construction is completed.

The Department also limits availability of financing to veterans on the basis of their personal credit status. The Department's current lending criteria conform to those of the USDVA for participation in the USDVA guaranty program for all Contracts of Purchase, including those not eligible for USDVA guarantees.

Department procedures are consistent with those established by USDVA for its loan guaranty program.

**Servicing.** Late penalty charges are applied to Contracts of Purchase that have a remaining amount due of \$25 or more at the close of any account month. A \$10 late penalty charge is imposed on Contracts of Purchase originated before October 1984. Contracts of Purchase originated during and after October 1984 are subject to a late penalty charge of 4% of the principal and interest portion of the installment, consistent with penalties authorized by USDVA.

The Department may, in any individual case and for good cause, permit the postponement from time to time, and upon such terms as it deems proper, of the payment of the whole or any part of any installment. Contracts of Purchase may also have terms in excess of 30 years if home improvement loans have been obtained, as discussed above. The terms of Contracts of Purchase guarantied by USDVA, however, cannot exceed 30 years and 32 days.

All Contracts of Purchase originated on or after April 1, 1998 are serviced under a contract with Leader under which Leader provides loan servicing, including USDVA reporting. Pursuant to such contract, Leader will service Contracts of Purchase until such time as the Department's new Integrated Loan Processing and Financial Information System is operational. Contracts of Purchase originated prior to April 1, 1998 are maintained under the Department's existing loan servicing system. All Contracts of Purchase are expected to be serviced after July 1, 1999 by the Department using its new information system.

**Prepayments.** The Department currently imposes on Contracts of Purchase executed prior to April 1, 1998 a prepayment charge equivalent to 2% of the original purchase price if the Contract of Purchase is paid in full within two years of its origination date. After the two-year period has elapsed the veteran may prepay without charge any or all of the installments still remaining unpaid. In conformance with USDVA program requirements, there is no prepayment penalty on all Contracts of Purchase executed after April 1, 1998.

**Cancellations and Delinquencies.** The Department's policies regarding delinquencies and cancellations conform to USDVA loan guaranty program requirements. In the event of a failure to comply with any of the terms of a Contract of Purchase, the Department may cancel the Contract of Purchase and be released from all obligations, at law or in equity, to convey the property. In such event, the veteran's rights under the Contract of Purchase may be forfeited and all payments made by the veteran prior to termination of the Contract of Purchase deemed to be rental paid for occupancy. Upon such forfeiture, the Department takes possession of the property covered by the Contract of Purchase and resells it.

If a veteran does not make a payment by the close of the account month in which the payment is due (usually the 18th day of the month), the payment is considered "delinquent." A warning letter is issued on the 20th day of the same account month which advises the veteran that the account is delinquent. Department personnel initiate telephone contact with veterans with delinquent accounts. If the account remains delinquent through the second account month, a Notice of Intent to Cancel Contract is issued at the beginning of the third account month giving notice that the Contract of Purchase may be canceled at the end of the 30-day notice period unless the account is brought current. A schedule for liquidation of delinquent payments satisfactory to the Department is arranged during this period; however, if the account remains delinquent after such 30-day period and no schedule for liquidation of delinquent payments has been agreed upon, the Department may begin cancellation of the Contract of Purchase. The Department's headquarters Central Collections Unit monitors the delinquency throughout this process, orders a title search to identify any junior lienholders and forwards the pertinent information to the Department's Foreclosure Unit for further precancellation processing in accordance with the California Code of Regulations, Title 12, Section 344, Military and Veterans Affairs. Junior lienholders are identified

and sent notices giving them 30 days (40 days in the case of federal tax liens) to protect their interest by beginning foreclosure proceedings. If the account is not brought current during such notice period to junior lienholders and no junior lienholder proceeds with a foreclosure action to protect its interest, the Department's Foreclosure Unit cancels the contract, and a Notice of Cancellation is mailed to the veteran and recorded. The Department's Foreclosure Unit then takes steps to evict occupants and clear any remaining liens. If judicial action is required, the case is referred to the Department's Law Division for additional processing.

After all remaining liens are removed and the property is vacant, the repossessed property is repaired and improved and is marketed through the Department's centralized repossession sales unit. The Department is required to advertise and accept sealed offers after a 2-week period, and the property is sold to the highest acceptable bidder. If no acceptable bids are received, the property is sold through a real estate broker and a commission of between 3% to 6% of the selling price is paid.

Federal law provides certain protections to military personnel on active duty or reservists ordered to report for military service under The Soldiers' and Sailors' Civil Relief Act of 1940, as amended. If a veteran obtained a Contract of Purchase prior to the relevant period of military service, then during the period of military service the interest rate on the Contract of Purchase cannot exceed 6% (unless the ability of the veteran to pay interest in excess of 6% is not materially impaired by such military service). Also, the veteran may seek a stay (or a court may on its own motion grant a stay) of any court action or proceeding.

See Exhibit E—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Cancellations and Delinquencies" for additional information regarding the status of Contracts of Purchase.

**Interest Rates.** Contracts of Purchase originated prior to January 1, 1999 bear interest at a rate which is set at least annually by the Department, with the review of the Board and the Veterans' Finance Committee of 1943. Most of such Contracts of Purchase currently bear interest at a rate of 6.95%. The Veterans Code currently requires that, generally, all Contracts of Purchase originated prior to January 1, 1999 bear the same interest rate. In accordance with the current provisions of the Veterans Code, the interest rate for such Contracts of Purchase can be changed at any time and as often as necessary. The effective date of a higher rate of interest on Contracts of Purchase may occur only once in any calendar year unless a finding is made by the Board and the Veterans' Finance Committee of 1943 that such additional action is necessary to protect the solvency of the 1943 Fund.

Recent legislation (i) has eliminated the uniform interest rates requirement for Contracts of Purchase originated on or after January 1, 1999 and (ii) allows the Department to establish non-uniform fixed or variable interest rates for such Contracts of Purchase. The current interest rates for such Contracts of Purchase are: 5.95% for Contracts of Purchase financed using Qualified Mortgage Bond Proceeds, and 6.65% for all other loans. See "PLAN OF FINANCE AND DEPARTMENT'S RECENT PROGRAMMATIC CHANGES."

### **Loan Insurance**

As discussed above under "PLAN OF FINANCE AND DEPARTMENT'S RECENT PROGRAMMATIC CHANGES," the Department has completed several programmatic changes, including obtaining loan insurance from private primary mortgage insurers for certain existing Contracts of Purchase with high LTVs and USDVA guaranties for new Contracts of Purchase with high LTVs. The Department collects a funding fee of from 1.25% up to 3% of the Contract of Purchase amount, based on the LTV for all Contracts of Purchase which exceed an LTV of 80%. With respect to eligible Contracts of Purchase, this fee is paid to the USDVA for the cost of the loan guaranty. The fee may be paid in escrow by the buyer or seller, or it may be added to the base

loan amount. If the veteran or the property is not eligible for a USDVA loan guaranty, the funding fee is placed in the Self Insurance Mortgage Loss Set-Aside Account. A portion of the fee is used to purchase primary mortgage insurance. Any change to the insurance and guaranty expectations described under this subheading would require amending the Department's Program Operating Procedures and delivering a new Cash Flow Statement.

**Primary Mortgage Insurance.** The Department has purchased primary mortgage insurance for a pool of certain Contracts of Purchase with LTVs above 80% but not to exceed 97%. This insurance is being provided through a contract with CMAC. The CMAC policy provides coverage, retroactively to February 1, 1998, for aggregate losses incurred on Contracts of Purchase in the pool, following property disposition, above an aggregate 2% deductible based upon a percentage of originally insured balances. Under the CMAC policy, once the aggregate deductible has been reached, insurance claims may be made based upon the individual LTV of the particular defaulted Contract of Purchase, as set forth below. For these purposes, LTV is calculated using the original appraised value of the property.

**CMAC Mortgage Insurance Coverage Rates Subject to a  
Deductible of 2% of the Total Original Dollar Amount of the Insured Pool**

<u>LTV Category</u>	<u>% of Coverage</u>
95.01% to 97.00% .....	35%
90.01% to 95.00% .....	30%
85.01% to 90.00% .....	25%
80.01% to 85.00% .....	17%

The Department intends to include Contracts of Purchase with 80.01% to 97% LTV ratios that are not qualified for USDVA guaranties (except mobile homes in parks, construction loans and home improvement loans all of which are covered by the Department) in the 2% aggregate loss primary mortgage insurance contract with CMAC unless and until the aggregate principal amount of Contracts of Purchase so insured by CMAC exceeds the coverage amount of the insurance contract. At present the remaining available coverage amount under such CMAC contract is \$250,000,000, although Contracts of Purchase in an aggregate principal amount of approximately \$105,000,000 are currently in process for coverage under the CMAC policy. See Exhibit E—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Contracts of Purchase—Existing Contracts of Purchase."

**USDVA Guaranty Program.** The Department has been approved by the USDVA as a "supervised lender with automatic processing authority" as of March 10, 1998. On July 27, 1998, the Department received USDVA approval under the Lender Appraisal Processing Program ("LAPP") to process appraisals and determine reasonable value without prior USDVA review. The Department seeks USDVA loan guaranties for all Contracts of Purchase with an LTV ratio of 80% or higher, unless the Contract of Purchase is not eligible for USDVA guaranty. Contracts of Purchase not eligible for guaranty are primarily contracts with veterans who have previously used their USDVA guaranty eligibility and do not qualify for reinstatement, and contract for the purchase of new homes not inspected by USDVA during construction. A very small number of veterans have service that meets Veterans Code eligibility requirements but does not meet USDVA eligibility requirements.

The Servicemen's Readjustment Act of 1944, as amended, permits a veteran (or in certain instances the veteran's spouse) to obtain a mortgage loan guaranty from USDVA covering mortgage financing of the purchase or construction of a one-to-four family dwelling unit at interest rates permitted by USDVA. The USDVA program has no preset mortgage loan limits and permits the guaranty of mortgage loans of up to 30 years and thirty-two days' duration. Under the USDVA program, the maximum USDVA guaranty on a loan is the lesser of the veteran's available entitlement (a maximum of \$36,000, or if the original loan amount exceeds \$144,000, a maximum of

\$50,750), or (1) 50% of the original loan amount if such amount does not exceed \$45,000, (2) \$22,500 if the original loan amount is between \$45,000 and \$56,250, (3) the lesser of \$36,000 or 40% of the original loan amount, if such amount is between \$56,250 and \$144,000, or (4) the lesser of \$50,750 or 25% of the original loan amount, if such amount is in excess of \$144,000. The liability on the guaranty is reduced or increased pro rata with any reduction or increase in the amount of indebtedness, but in no event will the amount payable on the guaranty exceed the amount of the original guaranty. Notwithstanding the dollar and per centum limitations of the guaranty, a mortgage holder will ordinarily suffer a monetary loss only where the difference between the unsatisfied indebtedness and the proceeds of a foreclosure sale of a mortgaged property is greater than the original guaranty as adjusted. Extended periods without interest payments prior to foreclosure will also increase the potential for losses. In the event of a default in the payment of a USDVA loan, but prior to a suit or foreclosure, USDVA may, at its option, pay to a mortgage holder the unpaid balance of the obligation plus accrued interest and receive an assignment of the loan and security.

***Self Insurance Mortgage Loss Set-Aside.*** The Department has established a mortgage loss account within the 1943 Fund to be funded by mortgage insurance charges (funding fees) paid by veteran recipients of Contracts of Purchase that do not qualify for USDVA guarantees and high LTV Contracts of Purchase that are not insured under the CMAC policy. A portion of these moneys are used to purchase primary mortgage insurance.

### **Property and Life and Disability Insurance**

The Veterans Code and/or long-standing Department policy have called for a veteran to maintain certain insurance with respect to the property covered by a Contract of Purchase. Insurance must be in the amount and under the conditions specified by the Department, and is either provided by the Department or by insurance companies selected by the Department.

***Fire and Hazard Coverage.*** The Department self-insures for fire and hazard losses, using the 1943 Fund to make payments, up to a deductible. The Master Policy described below (the "Master Policy") provides coverage in excess of the deductible, except that the Master Policy does not cover mobile homes, condominiums or planned unit development properties covered by blanket insurance policies provided by homeowners' associations. The Master Policy is provided by a commercial insurer.

Under each Contract of Purchase, the veteran is required to pay the sum charged to his or her account to cover costs of providing the insurance coverage including the insurance premium due under the Master Policy described below with respect to his or her property. From the amount charged to each veteran, the Department retains a portion to provide the sums necessary to pay all losses up to \$1,250,000 per occurrence or \$10,000,000 per policy year. If the total losses from a single occurrence exceed \$1,250,000 or if the aggregate of all fire and hazard insurance losses for a policy year exceed \$10,000,000 liability for the excess will be covered under the Master Policy. The current Master Policy will expire on October 31, 1999.

The Master Policy is an all-physical loss form. Fire and hazard insurance coverage for participants in the Program is adjusted annually to reflect increasing building costs and is maintained on a guaranteed replacement cost basis for homes and on an actual cash value basis for outbuildings. A \$250 deductible payable by the veteran applies to each loss. Claims must be submitted within 12 months of loss. Each veteran with a Contract of Purchase pays an annual insurance premium equal to \$0.22 per \$100 of insured value which is prorated and included in the veteran's monthly installment. Claims adjustments and payments are made on behalf of the Department and the provider of the Master Policy by an affiliate of such provider.

***Disaster Indemnity Plan.*** The Department provides certain disaster indemnity and catastrophe real property insurance ("Disaster Indemnity Plan"). Neither such insurance nor the indemnity fund described below are payable from or a part of the 1943 Fund. The Disaster



Indemnity Plan indemnifies participants against the cost of repairing damage in excess of a deductible caused by flood, earthquake or other perils not covered by the fire and hazard insurance policy (not otherwise excluded). The deductible for flood losses is \$500 and the deductible for earthquake losses is \$500 or 5% of the amount of loss, whichever is higher. The catastrophe insurance has been obtained from a consortium of nineteen insurance companies for a total of \$50,000,000 of coverage with a \$4,000,000 per occurrence and in the aggregate annually; \$100,000 per occurrence maintenance deductible thereafter. The 1998 to 1999 annual premium for this coverage is \$2,710,000.

Each veteran in the Program participates in the Disaster Indemnity Plan and pays his or her pro rata share of the annual premium. Such payments are deposited in an indemnity fund created in the Treasury of the State to be utilized to pay the deductible discussed above. Each veteran pays an initial assessment of \$1.35 per \$1,000 of insured value, and any assessments as may be required to sustain the indemnity fund. The value of the indemnity fund as of June 30, 1998 was \$11,887,000.

Effective December 1, 1997, the Department has purchased individual flood policies through the Federal Emergency Management Agency ("FEMA") covering all properties financed by Contracts of Purchase that are located in designated flood zones. Coverage under this policy extends to December 1, 2000.

***Life and Disability Coverage.*** In the past, the Department self-insured from the 1943 Fund life and disability coverage for veterans with Contracts of Purchase. Following a period of significant and recurring losses incurred by the 1943 Fund (see "SELECTED FINANCIAL DATA OF THE 1943 FUND AND DEPARTMENT'S DISCUSSION"), the Department, effective June 1, 1996, replaced most of the Department's self-insured life and disability insurance program with an interim life and disability insurance plan (the "Life and Disability Plan") provided by PM Group Life Insurance Company ("PM Group"). Effective February 1, 1998, the interim plan after a competitive bidding process was replaced by a replacement, long-term life insurance and disability plan, also provided by PM Group Life Insurance. The Department continues to self-insure those veterans who were already receiving disability benefits at the time the Life and Disability Plan was implemented. Benefits are equal to the amount of the monthly Contract of Purchase payment at the time of their disability. Those benefits will continue under the provisions of the self-insured plan until the beneficiary returns to active employment or dies, or his contract is paid off. Loss reserves for these obligations have been actuarially determined. A portion of the required loss reserves are maintained under a third-party administrator agreement and are shown in the financial statements for the 1943 Fund as investments with insurance administrators. The remaining amount is unfunded, but reserved in the form of a loss against retained earnings. See "SELECTED FINANCIAL DATA OF THE 1943 FUND AND DEPARTMENT'S DISCUSSION."

Effective February 1, 1998, the Department implemented a new life and disability protection plan which is provided by PM Group. All holders of Contracts of Purchase who had life and disability coverage under the prior plan were transferred automatically to the new plan. Major elements of the life and disability coverage will continue unchanged for all currently insured Contract of Purchase holders up to age 60. For formerly insured holders of Contracts of Purchase under age 60, 100% of the loan balance is covered. Life insurance coverages at subsidized rates for those currently insured Contract of Purchase holders in the program over age 60 are limited to a maximum of the loan amount or \$75,000, if less, reducing in increments every 5 years to a maximum of \$5,000 after age 80. Such Contract of Purchase holders can obtain, at actuarial rates, full coverage. Holders of new Contracts of Purchase after February 1, 1998 are covered under a revised insurance plan. The Department continues to require life insurance coverage but in an amount sufficient to cover home payments for five, three or one year(s) depending on the health of the individual loan applicant. All new Contract of Purchase applicants must apply and must be provided the minimum life insurance coverage. Disability coverage for a period up to two years is

optional for new Contract of Purchase holders after February 1, 1998, but is a mandatory requirement for Contract of Purchase holders with Contracts of Purchase in existence prior to February 1, 1998. The disability insurance benefit provides home loan protection by paying the participant's monthly loan installment (including insurance premiums) for a maximum benefit period of two years per disability, unless due to a psychiatric condition which would then limit the maximum benefit period to 12 months. Additional, full coverage, life insurance may also be purchased as an option by new Contract of Purchase holders. Spouse life insurance coverage is available as an option. The new plan is an experience rate plan subject to annual rating reviews of insurance claims, expenses, risk charges, profits and premiums. In addition to the new insurance coverages, the Department has established a one-time \$5 million rate stabilization reserve, which the Department will retain with interest as part of the 1943 Fund.

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## **SUMMARY OF CERTAIN PROVISIONS OF THE RESOLUTION**

The following is a summary of certain provisions of the Resolution. These summaries do not purport to be comprehensive and reference should be made to the Resolution for a full and complete statement of its provisions.

### **Resolution to Constitute Contract (Section 101)**

In consideration of the purchase and acceptance of any and all of the Bonds issued under the Resolution by those who shall own the same from time to time, the Resolution shall be deemed to be and shall constitute a contract between the Department, the Trustee and the owners of the Bonds, and the pledges made in the Resolution and the covenants and agreements in the Resolution set forth to be performed by the Department or the Trustee shall be for the equal benefit, protection and security of the owners of any and all of the Bonds, all of which, without regard to the time or times of their issue or maturity, shall be of equal rank without preference, priority or distinction of any of the Bonds over any other of the Resolution, except as expressly provided in or permitted by the Resolution or by the applicable Series Resolution.

### **Pledge Effected by the Resolution (Section 102)**

For the purpose of fixing and declaring the terms and conditions upon which the Bonds are to be issued, executed, delivered, secured and accepted by the owners of the Bonds, and in order to secure the payment of all Bonds at any time issued and Outstanding under the Resolution and the interest thereon according to their tenor, purport and effect, and in order to secure the performance and observance of all the covenants, agreements and conditions therein and in the Resolution contained, the Department has adopted the Resolution, has pledged, conveyed and assigned, and, subject to the subordination provisions in favor of other debt holders of the Department contained in the definition in the Resolution of Pledged Property, does by the Resolution pledge, convey and assign the Pledged Property to the Trustee as security for the payment of the principal of, including redemption premium, if any, on the Bonds and the interest thereon for the equal and proportionate benefit and security, from time to time, of the owners of the Bonds, without preference, priority or distinction as to lien or otherwise, except as otherwise provided in the Resolution or as provided in an applicable Series Resolution, of any one Bond over any other Bond, by reason of priority in the issue, sale or negotiation thereof or otherwise, all in accordance with the terms of the Resolution.

### **Definitions (Section 103)**

In the Resolution and any resolution supplemental to the Resolution the following terms shall have the following meanings:

*"Account"* means an Account (and any subaccounts therein) created by or pursuant to the Resolution or a Series Resolution.

*"Accountant"* means an independent certified public accountant or firm of independent certified public accountants selected by the Department, who may be the accountant or firm of accountants who regularly audit the books of the Department.

*"Accrued Debt Service"* means, as of any date of determination and, as the context of the Resolution requires, with respect to all Bonds and/or all Veteran's General Obligation Bonds, the sum of:

- (a) the aggregate amount of scheduled interest and principal (except to the extent principal is otherwise to be redeemed pursuant to clause (b) or (c) hereof) to become due after

such date but on or before the end of the current Debt Service Year, less the product of (i) the number of whole months remaining in the current Debt Service Year and (ii) the Monthly Debt Service Requirement;

(b) the redemption price of bonds for which notice of redemption has been issued, provided such redemption price is to be paid from amounts on deposit in the Revenue Account; and

(c) the redemption price of bonds that the Department will be obligated to redeem prior to the end of the next succeeding Debt Service Year under the terms of any Series Resolution or Supplemental Resolution or resolution of issuance governing Veterans General Obligation Bonds, to the extent that such obligation arises on account of amounts on deposit in the Revenue Account.

*"Additional Bonds"* means any additional Bonds issued pursuant to Section 209 of the Resolution.

*"Amortized Value"* means the purchase price of securities, excluding accrued interest, plus an amortization of any discount or less an amortization of any premium included in the purchase price. The premium or discount shall be amortized on an actuarial basis, such that the Amortized Value at any time equals the price at which the yield on a security equals the yield of such security as of its original purchase. In the case of an Investment Obligation callable at the option of the issuer thereof, the original yield and Amortized Value shall be computed on the assumption that, (i) for securities purchased at a premium, such security is redeemed as of the first possible redemption date, provided, that after such redemption date, such value of the Investment Security shall be computed at par, or (ii) for securities purchased at a discount, such security is held to maturity.

*"Applicable Fund Parity Percentage"* means 50% or such other percentage set forth in the Program Operating Procedures. But see "SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS—Maintenance of Fund Parity" for current percentage.

*"Appreciated Amount"* means with respect to a Deferred Interest Bond, (i) as of any date of computation with respect to any Deferred Interest Bond up to the date, if any, set forth in the Series Resolution authorizing such Deferred Interest Bond as the date on which such Deferred Interest Bond shall commence to bear interest payable thereafter on applicable interest payment dates, an amount equal to the initial principal amount of such Deferred Interest Bond plus the interest accrued on such Deferred Interest Bond from the date of original issuance of such Deferred Interest Bond to the applicable interest payment date next preceding the date of computation or the date of computation if an applicable interest payment date, such increased amount to accrue at the rate per annum set forth in the Series Resolution authorizing such Deferred Interest Bond, compounded on each applicable interest payment date, plus, if such date of computation shall not be an applicable interest payment date, a portion of the difference between the Appreciated Amount as of the immediately preceding applicable interest payment date (or the date of original issuance if the date of computation is prior to the first applicable interest payment date succeeding the date of original issuance) and the Appreciated Amount as of the immediately succeeding applicable interest payment date, calculated based upon an assumption that the Appreciated Amount accrues in equal daily amounts on the basis set forth in the Series Resolution authorizing such Deferred Interest Bonds; and (ii) as of any date of computation on and after the date, if any, set forth in the Series Resolution authorizing such Deferred Interest Bond as the date on which such Deferred Interest Bond shall commence to bear interest payable thereafter on applicable interest payment dates, the Appreciated Amount as of such current interest payment commencement date.

*"Authorized Representative" or "Authorized Officer"* means the Secretary of Veterans Affairs, Undersecretary of Veterans Affairs, Deputy Secretary of Operations, Deputy Secretary of Administration or any other authorized representative as from time to time may be designated by the Secretary in writing to the Trustee as authorized to act under the Resolution on behalf of the Department.

*"Bond Act"* means the Veterans' Revenue Debenture Act of 1970 (constituting Chapter 7 of Division 4 of the Veterans Code), as now in effect and as it may from time to time hereafter be amended or supplemented.

*"Bondowner" or "owner of Bonds" or "Holder" or "Bondholder"* means the registered owner of any registered Bond.

*"Bond Registrar"* means the Trustee as the party responsible for maintenance of the Bond registration books of the Department pursuant to Section 208 of the Resolution.

*"Bond Reserve Account"* means the Bond Reserve Account established pursuant to Section 401 of the Resolution.

*"Bond Reserve Requirement"* means, as of any particular date of calculation, an amount equal to the aggregate of all amounts established for all Series of Bonds Outstanding in the Series Resolutions authorizing the issuance of such Bonds, at least equal in the aggregate to three per centum (3%) of the aggregate Outstanding principal amount of the Bonds with interest rates fixed to the maturity thereof.

*"Bonds"* means Revenue Bonds.

*"Cash Equivalent"* means a Letter of Credit, Insurance Policy, Surety, Guarantee or other Security Arrangement (as defined and provided for in a Series Resolution providing for the issuance of Bonds or in a Supplemental Resolution), provided by an institution which has received a rating of its claims paying ability from each of the Rating Agencies at least equal to the then-existing respective rating on the Bonds or whose unsecured debt securities are rated at least the then-existing respective rating on the Bonds (or the highest rating of short-term obligations if the Cash Equivalent is a short-term instrument) by the Rating Agencies.

*"Cash Flow Statement"* means a Cash Flow Statement conforming to the requirements of Section 607 of the Resolution.

*"Certificate of the Department"* means an instrument in writing signed by an Authorized Representative.

*"Committee"* means the Veterans' Debenture Finance Committee created by the Bond Act.

*"Contract of Purchase"* means any contract of purchase entered into by the Department and a veteran or other eligible person covering any property (whether residential or otherwise) purchased or acquired by the Department with moneys in the 1943 Fund or any other obligation representing a program investment of such moneys irrespective of the form of such obligation.

*"Costs of Issuance"* means all items of expense payable or reimbursable directly or indirectly by the Department and related to the authorization, sale, issuance and remarketing of the Bonds, as certified by an Authorized Representative.

*"Credit and Liquidity Support Expenses"* means, with respect to a Series of Bonds or a series of Veterans General Obligation Bonds (as the context requires), as set forth in a Series Resolution or Supplemental Resolution, or resolution of issuance governing such series of Veterans General Obligation Bonds, respectively, the amounts necessary to pay any fees and reimbursement in connection with tender option features, letters of credit, standby bond purchase agreements, bond insurance and other forms of credit and liquidity support related thereto.

*"Debt Service Year"* means the year beginning on the second day of October and ending on the first day of October in the next succeeding year, or any other twelve-month period hereafter selected and designated as such in the Program Operating Procedures.

*"Deferred Interest Bond"* means any Bond designated as such by the Series Resolution authorizing the issuance of such Bond.

*"Department Request"* means a written request or direction of the Department signed by an Authorized Representative.

*"Excess Revenues"* means, as of any date of calculation, the amount of all Revenues held in the Revenue Account in excess of Accrued Debt Service (as adjusted for any use of Revenues contemplated at the time of such calculation).

*"Expenses"* means any moneys required by the Department to pay, or to be set aside to pay, the expenses of the Trustee and any expenses which the Department may lawfully pay from the 1943 Fund (whether or not related to the Bonds), except (i) as limited with respect to any Series of Bonds by the applicable Series Resolution, and (ii) that Credit and Liquidity Support Expenses shall not be included in the definition of "Expenses"; provided, however, that such expenses related to Cash Equivalents shall not be excluded.

*"Federal Tax Code"* means applicable provisions of the Internal Revenue Code of 1954, as amended, and the Internal Revenue Code of 1986, as amended, and the applicable regulations thereunder.

*"Fiscal Year"* means the year beginning on the first day of July and ending on the last day of June in the next succeeding year, or any other twelve-month period selected and designated as the official fiscal year period of the Department.

*"Fitch"* means Fitch IBCA, Inc., and includes any successor thereto.

*"Fund Parity"* means, on any determination date, (A) an amount equal to the difference between (i) all assets in the 1943 Fund and in the Accounts established under the Resolution, and (ii) the aggregate Outstanding principal amount of all Bonds and all Veterans General Obligation Bonds (plus accrued interest) reduced by (B) allowances and reserves for loss coverage on Contracts of Purchase, loss coverage on properties subject to Contracts of Purchase, and life and disability coverage on persons obligated under Contracts of Purchase, as specified in the Program Operating Procedures.

*"Government Obligations"* means bonds or interest-bearing notes or obligations of the United States, or those for which the faith and credit of the United States are pledged for the payment of principal and interest.

*"Investment Obligations"* means, any of the following which at the time of purchase are legal investments under the laws of the State of California for moneys held under the Resolution and then proposed to be invested therein:

(1) Government Obligations;

(2) Bonds, consolidated bonds, collateral trust debentures, consolidated debentures, or other obligations issued by federal land banks or federal intermediate credit banks established under the Federal Farm Loan Act, as amended, debentures and consolidated debentures issued by the Central Bank for Cooperatives and banks for cooperatives established under the Farm Credit Act of 1933, as amended, bonds or debentures of the Federal Home Loan Banks, stock, bonds, debentures and other obligations of the Government National Mortgage Association or the Federal National Mortgage Association established under the National Housing

Act as amended, obligations of the Federal Home Loan Mortgage Corporation, and bonds, notes and other obligations issued by the Tennessee Valley Authority under the Tennessee Valley Authority Act as amended;

(3) interest-bearing demand or time deposits in banks or savings and loan associations, which, to the extent they are not insured by federal deposit insurance, are collateralized by securities eligible to secure public deposits in the State, or which are issued by an institution, the senior unsecured debt of which is rated in one of the top two rating categories of a Rating Agency;

(4) negotiable certificates of deposit issued by a nationally or state-chartered bank or savings and loan association or by a state-licensed branch of a foreign bank which, to the extent they are not insured by federal deposit insurance, are collateralized by securities eligible to secure public deposits in the State, or which are issued by an institution the senior unsecured debt of which is rated in one of the top two rating categories by a Rating Agency;

(5) repurchase agreements backed by or related to obligations described in (i) or (ii) above with any institution whose unsecured debt securities are rated, or which agreements are rated, at least equal to the then existing rating on the Bonds (or the highest rating of short-term obligations if the investment is a short-term obligation) by a Rating Agency;

(6) (1) investment agreements, secured (by collateralization, guaranty or otherwise) or unsecured, with any institution, or fully guaranteed by any institution, whose unsecured debt securities are rated at least equal to the then existing rating on the Bonds (or the highest rating of short-term obligations if the investment is a short-term obligation) by a Rating Agency, or (2) any investment agreement that is secured (by collateralization, guaranty or otherwise), to such extent that the investment agreement itself is the subject of such a rating or the Bonds are the subject of written confirmation from a Rating Agency that investment of amounts in such an investment agreement will not cause the outstanding rating of the Bonds by such Rating Agency to be withdrawn, downgraded or suspended;

(7) commercial paper (having original maturities of not more than 180 days) rated in the highest rating category by a Rating Agency;

(8) direct and general obligations of or obligations unconditionally guaranteed by any state or political subdivision thereof, the payment of the principal of and interest on which the full faith and credit of the state or such political subdivision is pledged, and certificates of participation in any such obligations (which obligations may be subject to annual appropriations), which obligations or certificates of participation, respectively, are rated at least equal to the then existing rating of the Bonds by a Rating Agency;

(9) investments in any mutual fund the portfolio of which is limited to Investment Obligations, including any proprietary mutual fund of the Trustee or co-Trustee for which the Trustee or co-Trustee or an affiliate is investment advisor or provided other services to such mutual fund and receives reasonable compensation for such services (and if such mutual fund consists solely of Government Obligations, then such fund will constitute "Government Obligations" for the purposes of the Resolution);

(10) obligations of any state, political subdivision, political corporation or agency, the payment of principal, redemption price, if any, and interest on which is irrevocably secured by Government Obligations; and

(11) deposits in the Surplus Money Investment Fund in the Treasury of the State.

Provided, that it is expressly understood that the definition of Investment Obligations shall be, and be deemed to be, expanded, or new definitions and related provisions shall be added to the

Resolution by a Supplemental Resolution adopted and filed in accordance with Section 1001(j) of the Resolution thus permitting investments with different characteristics from those permitted which the Department deems from time to time to be in the interests of the Department to include as Investment Obligations;

For purposes of the definition, "institution" means an individual, partnership, corporation, trust or unincorporated organization, or a government or agency, instrumentality, program, account, fund, political subdivision or corporation thereof.

If the rating of any Investment Obligation purchased pursuant to the Resolution is downgraded, suspended or withdrawn by any Rating Agency, the Trustee is not required to sell such Investment Obligation but may retain the same under the Resolution.

*"Liquidation/Insurance Proceeds"* means amounts representing proceeds of (1) the sale or other disposition of any property subject to any Contract of Purchase, whether upon cancellation of said Contract of Purchase (on account of default or any other cause) or for any other cause, exclusive of amounts so recovered and required by law, contract or resolution of the Department to be otherwise applied, and (2) compensation for losses incurred with respect to the property subject to any Contract of Purchase from the proceeds of condemnation, title insurance, hazard insurance, or primary or pool insurance of the Contracts of Purchase (including Veterans Administration guaranties), exclusive of amounts recovered in respect of such losses to the extent required to be otherwise applied pursuant to the applicable law, contract or resolution of the Department.

*"Loan Loss Account"* means the Loan Loss Account established pursuant to Section 401 of the Resolution.

*"Loan Loss Requirement"* means, as of any particular date of calculation, an amount established in the current Cash Flow Statement which, when added to the Bond Reserve Requirement, shall not exceed ten percent (10%) of the initial principal amount of all Series of which any Bonds are Outstanding or such larger amount as may be provided in a Supplemental Resolution adopted pursuant to Section 1001(m) of the Resolution.

*"Monthly Debt Service Requirement"* means, as of any date of determination, one-twelfth ( $\frac{1}{12}$ ) of the aggregate amount of scheduled interest and principal to become due during the Debt Service Year in which such date falls, as computed on the first day of such Debt Service Year.

*"Moody's"* means Moody's Investors Service, Inc., and includes any successor thereto.

*"1943 Fund"* means the Veterans' Farm and Home Building Fund of 1943, established in the Treasury of the State by Section 988 of the Veterans Code.

*"Outstanding Bonds"* means, as of any date, all Bonds theretofore authenticated and delivered by the Trustee under the Resolution, except:

- (a) any Bond deemed paid in accordance with Section 411(b) of the Resolution;
- (b) any Bond canceled by, or delivered for cancellation to, the Trustee because of payment at maturity or redemption or purchase prior to maturity;
- (c) any Bond deemed paid in accordance with the provisions of Section 303 of the Resolution;
- (d) any Bond deemed paid in accordance with the provisions of Section 1101 of the Resolution; and
- (e) any Bond in lieu of or in substitution for which another Bond shall have been authenticated and delivered pursuant to Section 211 of the Resolution, unless proof satisfactory to the Trustee is presented that any Bond for which a Bond in lieu thereof or in substitution



therefor shall have been authenticated and delivered is held by a bona fide purchaser, as that term is defined in Article Eight of the Uniform Commercial Code of the State, as amended, in which case both the Bond so substituted and replaced and the Bond or Bonds authenticated and delivered in lieu thereof or in substitution therefor shall be deemed Outstanding.

*"Pledged Property"* means (a) an undivided interest in the assets of the 1943 Fund, other than any GO Bond Series Bond Proceeds Subaccount, which undivided interest shall be secondary and subordinate to the rights of the holders of Veterans General Obligation Bonds to receive payment of debt service thereon from amounts in the 1943 Fund under any general obligation veterans bond act, (b) any amounts held in the Bond Reserve Account, and (c) any amounts in the Loan Loss Account, except amounts in any Rebate Account and except that the pledge established in a Series Resolution may be limited in purpose and time, as set forth in the Series Resolution.

*"Primary Contract of Purchase Coverage"* means coverage in the form of primary mortgage insurance, guaranty (including by United States Department of Veterans Affairs guaranty) or otherwise of loss from Contract of Purchase defaults as provided in the Program Operating Procedures.

*"principal"* means (a) as such term references the principal amount of a Deferred Interest Bond or Deferred Interest Bonds, the Appreciated Amount thereof, and (b) as such term references the principal amount of any other Bond or Bonds, the principal amount at maturity of such Bond or Bonds.

*"Proceeds Account"* means the Proceeds Account established pursuant to Section 401 of the Resolution.

*"Program"* means the finance program of the Department pursuant to which the Department will issue the Bonds and Veterans General Obligation Bonds and apply the proceeds thereof to finance Contracts of Purchase.

*"Program Acts"* means the Veterans' Farm and Home Purchase Act of 1943 (constituting Article 3 of Chapter 6 of Division 4 of the Veterans Code) and the Veterans' Farm and Home Purchase Act of 1974 (constituting Article 3.1 of Chapter 6 of Division 4 of the Veterans Code), as now in effect and as they may from time to time hereafter be amended or supplemented.

*"Program Operating Procedures"* means, at any time, the Department's program operating procedures governing the discretionary activities of the Department, in the then current form, as described in Section 606 of the Resolution.

*"Rating Agency"* means, at any time, any bond rating agency, including Fitch, Moody's and S&P, that shall have rated any of the Bonds at the request of the Department and shall be maintaining ratings on such Bonds at such time.

*"Rating Confirmation"* means, with respect to any action or financial condition described in the Resolution, written confirmation from each of the Rating Agencies that the taking of such action or the existence of such financial condition shall not cause the outstanding ratings by such respective Rating Agencies of all Bonds which are not rated based solely on the credit of a bond insurer or other guarantor to be withdrawn, downgraded or suspended.

*"Rebate Account"* means any Account of that name established by the Department pursuant to Section 401(c) of the Resolution.

*"Redemption Price"* means, with respect to a Bond or portion thereof, the portion of the principal amount of such Bond or portion plus the applicable premium, if any, payable upon redemption thereof in the manner contemplated in accordance with its terms pursuant to the provisions of the Resolution and any Series Resolution.

*"Restricted Recoveries"* means, as set forth or referenced in the Series Resolution authorizing a Series of Bonds or in a resolution of issuance authorizing a series of Veterans General Obligation Bonds, or as otherwise designated in the Program Operating Procedures, that portion of prepayments and scheduled repayments of principal on Contracts of Purchase financed (directly or indirectly) by or credited to such Series of Bonds or series of Veterans General Obligation Bonds, respectively, to the extent such amounts are required by the Federal Tax Code or by the terms of such Series Resolution or resolution of issuance, respectively, to be applied to redemption of Bonds or Veterans General Obligation Bonds.

*"Revenue Account"* means the Revenue Account established pursuant to Section 401 of the Resolution.

*"Revenues"* means all moneys received by or on behalf of the Department representing (i) principal and interest payments on the Contracts of Purchase including all prepayments representing the same and all prepayment premiums or penalties received by or on behalf of the Department in respect to the Contracts of Purchase, (ii) interest earnings received on the investment of amounts to the extent deposited in the Revenue Account pursuant to Section 502 of the Resolution, (iii) amounts transferred to the Revenue Account from the Bond Reserve Account or the Loan Loss Account, and (iv) any other amounts payable by parties executing Contracts of Purchase or private participants in the Program or related to recoveries on defaulted Contracts of Purchase, including origination and commitment fees, servicing acquisition fees, and Liquidation/Insurance Proceeds, except to the extent not included as "Revenues" pursuant to the provisions of any Series Resolution.

*"S&P"* means Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc., and includes any successor thereto.

*"Series Certificate"* means a Certificate of the Department which shall be dated as of the date of sale and shall be executed (or re-executed in final form) and delivered on the date of issuance of the applicable Series of Bonds.

*"Series Proceeds Subaccounts"* means, collectively, the Revenue Bond Series Proceeds Subaccounts and the GO Bond Series Proceeds Subaccounts.

*"Series Recycling Subaccounts"* means, collectively, the Revenue Bond Series Recycling Subaccounts and the GO Bond Series Recycling Subaccounts.

*"Series Resolution"* means a Supplemental Resolution of the Committee authorizing the issuance of a Series of Bonds and including any Series Certificate delivered pursuant thereto.

*"Series Restricted Recoveries Subaccounts"* means, collectively, the Revenue Bond Series Restricted Recoveries Subaccounts and the GO Bond Series Restricted Recoveries Subaccounts.

*"Series Revenue Subaccounts"* means, collectively, the Revenue Bond Series Revenue Subaccounts and GO Bond Series Revenue Subaccounts.

*"State"* means the State of California.

*"Supplemental Contract of Purchase Coverage"* means the coverage, if any, of loss from Contract of Purchase defaults provided in the Program Operating Procedures which supplements any Primary Contract of Purchase Coverage.

*"Supplemental Resolution"* means any resolution of the Committee supplementing or amending the Resolution.

*"Veterans Debenture Fund"* means the Veterans Debenture Revenue Fund established in the Treasury of the State by Section 1003.11 of the Veterans Code.

*"Veterans Code"* means the Military and Veterans Code of the State of California.

*"Veterans General Obligation Bonds"* means, as of any given time, general obligation bonds of the State the proceeds of which were required to be deposited in the 1943 Fund (or returned to the General Fund or in the Pooled Money Investment Account in the State Treasury in repayment of amounts withdrawn from said General Fund or the Pooled Money Investment Account and deposited in the 1943 Fund) and which are at such given time outstanding.

#### **Miscellaneous Definitions (Section 104)**

Unless the context shall otherwise indicate, words which import the singular shall include the plural, and words which import the plural shall include the singular. The word "person" shall mean any individual, corporation, partnership, joint venture, association, joint-stock company, trust, unincorporated organization or government or any agency or political subdivision thereof. The words "of the Resolution", "herein", "hereto", "by the Resolution" and "hereunder" refer to the entire Resolution. The words "interest payment date" mean with respect to any Series of Bonds, the interest payment date(s) established in the applicable Series Resolution, regardless of whether the referenced Bonds are interest-bearing or not.

Any reference to a rating category shall mean the category published by a Rating Agency without reference to numbered or lettered annotations or pluses and minuses.

#### **Authentication of Bonds (Section 205)**

Only such of the definitive Bonds as shall have endorsed thereon a certificate of authentication substantially in the form set forth in the applicable Series Resolution, duly executed by the Trustee, shall be entitled to any benefit or security under the Resolution. No definitive Bond shall be valid or obligatory for any purpose unless and until such certificate of authentication shall have been duly executed by the Trustee, and such certificate of the Trustee upon any such Bond shall be conclusive evidence that such Bond has been duly authenticated and delivered under the Resolution. The Trustee's certificate of authentication on any definitive Bond shall be deemed to have been duly executed if signed by an authorized officer of the Trustee, but it shall not be necessary that the same officer sign the certificate of authentication on all of the Bonds that may be issued under the Resolution at any one time.

#### **Exchange of Bonds (Section 206)**

Subject to, and in accordance with, Section 207 of the Resolution, Bonds, upon surrender thereof at the principal office of the Trustee in Sacramento California, together with an assignment duly executed by the registered owner or his attorney or legal representative in such form as shall be satisfactory to the Trustee, may, at the option of the registered owner thereof, be exchanged for an equal aggregate principal amount of Bonds of like tenor and of the same Series (and subseries, if applicable) and maturity, bearing interest at the same rate, of any denomination or denominations authorized by the Resolution.

#### **Negotiability, Registration and Registration of Transfer of Bonds (Section 207)**

The transfer of any Bond may be registered only upon the books kept for the registration of, and registration of transfers of, Bonds upon surrender thereof to the Trustee together with an assignment duly executed by the registered owner or his attorney or legal representative in such form as shall be satisfactory to the Trustee. Upon any such registration of transfer of a Bond, the Department shall execute and the Trustee shall authenticate and deliver in exchange for such Bond a new Bond or Bonds, registered in the name of the transferee, in any denomination or denominations authorized by the Resolution, in an aggregate principal amount equal to the principal amount of such Bond of like tenor and of the same Series (and subseries, if applicable) and maturity and bearing interest at the same rate.

### **Issuance of the Bonds (Section 209)**

Each Series Resolution authorizing the issuance of a Series of Bonds shall specify and determine:

- (a) The authorized principal amount of such Series of Bonds;
- (b) The purposes for which such Series of Bonds are being issued which shall be one or more of the following purposes: (i) the financing of Contracts of Purchase, (ii) the making of such deposits in amounts, if any, required by the Resolution or the Series Resolution to be paid into various Accounts or the direct payment of Costs of Issuance, or (iii) the refunding of all or any part of the Bonds of any Series (including any Bonds not deemed Outstanding under the Resolution pursuant to Section 411(b)) or, to the extent permitted by law, Veterans General Obligation Bonds, including the payment of any redemption premium thereon (or premium, to the extent permitted by law, included in the purchase price if purchased in lieu of redemption);
- (c) The maturity date or dates, the amounts of each maturity, and the interest payment dates of the Bonds of such Series;
- (d) The interest payment dates, and rate or rates, of the Bonds of such Series or method of determining the same;
- (e) The denomination or denominations of, and the manner of dating, numbering and lettering the Bonds of each Series;
- (f) In the case of Term Bonds, if any, provision for Mandatory Sinking Account Payments;
- (g) The Redemption Price or Redemption Prices, if any, the time or times and the terms and conditions upon which the Bonds of such Series may be redeemed prior to their maturities, including without limitation the method of selection for redemption as among maturities;
- (h) The amounts to be deposited from the proceeds of such Series of Bonds in the Accounts created and established by the Resolution and the Series Resolution;
- (i) That notwithstanding any other provision of the Series Resolution, upon issuance, sale and delivery of such Series of Bonds, so much of such proceeds of the Bonds of such Series shall be credited to the Bond Reserve Account so that the amount in such fund shall be at least equal to the Bond Reserve Requirement calculated immediately after the delivery of such Series of Bonds;
- (j) That notwithstanding any other provision of the Series Resolution, upon sale and delivery of such Series of Bonds, so much of such proceeds of the Bonds of such Series shall be credited to the Loan Loss Account so that the amount in such fund shall be at least equal to the Loan Loss Requirement calculated immediately after the delivery of such Series of Bonds;
- (k) The manner in which Bonds of such Series are to be sold and provisions for the sale thereof;
- (l) The form of any credit enhancement or liquidity support for such Series of Bonds; and
- (m) Any other provisions deemed advisable by the Department not in conflict with the provisions of the Resolution.

Said Bonds shall be executed substantially in the form and manner set forth in the Resolution and shall be deposited with the Trustee for authentication, but before said Bonds shall be authenticated and delivered by the Trustee, there shall be on file with the Trustee the following:

(a) A copy, duly certified by an Authorized Representative, of the Resolution and the Series Resolution for such Series of Bonds;

(b) A Certificate of the Department to the effect that no Event of Default shall have occurred and then be continuing;

(c) An opinion of nationally recognized bond counsel stating in the opinion of such counsel that (i) the Resolution and the applicable Series Resolution have been duly adopted and are valid and binding upon the Department and (ii) said Bonds are valid and legally binding special obligations of the Department secured in the manner and to the extent set forth in the Resolution and the applicable Series Resolution and are entitled to the benefit, protection and security of the provisions, covenants and agreements contained therein;

(d) A Cash Flow Statement conforming to the requirements of Section 607 of the Resolution;

(e) With respect to refunding Bonds, a certificate of an Authorized Representative stating that the proceeds (excluding accrued interest but including any premium) of such refunding Bonds, together with any moneys to be withdrawn from the Bond Reserve Account by the Trustee, and any other moneys which have been made available to the Trustee for such purposes, and the principal of and the interest on the investment of such proceeds or any such moneys, will be not less than an amount sufficient to pay the principal of and the redemption premium, if any, on the Bonds to be refunded and the interest which will become due and payable on or prior to the date of their payment or redemption, the expenses in connection with such refunding and to make any required deposits to the Bond Reserve Account and the Loan Loss Account and specifying transfers, if any, from the Series Proceeds Subaccount applicable to the Series of Bonds to be refunded and the refunding Bonds;

(f) With respect to refunding Bonds, if all or part of the refunded Bonds are to be redeemed prior to maturity, irrevocable instructions from an Authorized Representative of the Department to the Trustee to redeem the applicable Bonds; and

(g) a Rating Confirmation;

(h) A request and authorization to the Trustee on behalf of the Department, signed by an Authorized Representative, to authenticate and deliver the Bonds to the purchaser or purchasers therein identified upon payment to the Trustee for the account of the Department of the purchase price therefor.

When the documents mentioned in clauses (a) to (h), inclusive, of Section 209 shall have been filed with the Trustee and when the Bonds described in the Series Resolution mentioned in clause (a) above shall have been executed and authenticated as required by the Resolution, the Trustee shall deliver such Bonds at one time to or upon the order of the purchaser or purchasers named in the request and authorization mentioned in clause (h) of this Section, but only upon payment to the Trustee of the purchase price of said Bonds. The Trustee shall be entitled to rely upon such request and authorization as to the amount of such purchase price.

Simultaneously with the delivery of such Bonds the Trustee shall deposit or credit the proceeds of said Bonds into the applicable Revenue Bond Series Proceeds Subaccount of the Proceeds Account. Unless otherwise provided in the applicable Series Resolution, the Trustee shall apply such proceeds together with any other available funds, as follows:

(i) an amount shall be transferred to and deposited to the credit of the Bond Reserve Account such that the amount on deposit in such Account will at least equal the Bond Reserve Requirement (with respect to refunding Bonds, after giving effect to the refunding);

(ii) an amount shall be transferred to and deposited to the credit of the Loan Loss Account such that the amount on deposit in such Account will at least equal the Loan Loss Requirement (with respect to refunding Bonds, after giving effect to the refunding); and

(iii) an amount to be transferred to and deposited into any Account or for any purpose not referred to in clauses (i) or (ii) above as provided in the applicable Series Resolution.

#### **Transfers Outside Book-Entry System (Section 214)**

In the event (i) the Securities Depository determines not to continue to act as Securities Depository for any Series of the Bonds, or (ii) the Department and the Trustee determine that the Securities Depository shall no longer so act and the Department delivers a written certificate to the Trustee to that effect, then the Department will discontinue the book-entry system with the Securities Depository with respect to such Series. If the Department and the Trustee determine to replace the Securities Depository with another qualified securities depository, the Department shall prepare or direct the preparation of a new, single, separate, fully registered bond for each of the maturities of the Bonds of such Series, registered in the name of such successor or substitute qualified securities depository or its nominee, or make such other arrangements acceptable to the Department and the Securities Depository as are not inconsistent with the terms of the Resolution or any Supplemental Resolution. If the Department and the Trustee fail to identify another qualified securities depository to replace the Securities Depository, then the Bonds of such Series shall no longer be restricted to being registered in the registration books of the Trustee in the name of the Nominee, but shall be registered in whatever name or names the Bondowner of Bonds transferring or exchanging Bonds shall designate in accordance with the Resolution. Notwithstanding anything in Section 214 of the Resolution to the contrary, the book-entry system may not be discontinued within the period commencing 15 days prior to the date of mailing a notice of redemption and ending on the redemption date specified in such notice.

#### **Payments and Notices to the Nominee (Section 215)**

Notwithstanding any other provision of the Resolution or any Supplemental Resolution to the contrary, so long as any Bond is registered in the name of the Nominee, all payments with respect to principal of, premium, if any, and interest on such Bond and all notices with respect to such Bond shall be made and given, respectively, as provided in the applicable Representation Letter or as otherwise instructed by the Securities Depository.

#### **Effect of Calling for Redemption (Section 303)**

On the date so designated for redemption if the conditions precedent, if any, to such redemption have been satisfied, any required notice which has not been waived having been given in the manner and under the conditions in the Resolution above provided, the Bonds or portions of Bonds so called for redemption shall become and be due and payable at the Redemption Price provided for redemption of such Bonds or portions thereof on such date, and, if sufficient money or Government Obligations (the principal of and interest on which will provide sufficient money for payment of the Redemption Price and the accrued interest) are held by the Trustee in trust for the owners of the Bonds or portions thereof to be redeemed, as provided in the Resolution, such Bonds or portions thereof shall cease to be Outstanding under the provisions of the Resolution, interest on the Bonds or portions of Bonds so called for redemption shall cease to accrue, such Bonds or portions of Bonds shall cease to be entitled to any benefit or security under the Resolution and the owners of such Bonds or portions of Bonds shall have no rights in respect of the Resolution, except to receive payment of the Redemption Price thereof and the accrued interest thereon to the date of redemption and, to the extent provided in Section 304 of the Resolution, to receive Bonds for any unredeemed portion of Bonds.

**Establishment of Accounts (Section 401)**

- (a) The Resolution creates the following Accounts within the 1943 Fund:

Proceeds Account

Revenue Bond Series Proceeds Subaccounts  
Revenue Bond Series Recycling Subaccounts  
GO Bond Series Proceeds Subaccounts  
GO Bond Series Recycling Subaccounts

Revenue Account

Revenue Bond Series Restricted Recoveries Subaccounts  
Revenue Bond Series Revenue Subaccounts  
GO Bond Series Restricted Recoveries Subaccounts  
GO Bond Series Revenue Subaccounts

- (b) The Resolution creates the following Accounts within the Veterans Debenture Fund and designated as set forth below:

Bond Reserve Account

Series Bond Reserve Subaccounts

Loan Loss Account

Series Loan Loss Subaccounts

**Proceeds Account (Section 402)**

(a) Upon the issuance of a Series of Bonds or a series of Veterans General Obligation Bonds, unless otherwise provided in the applicable Series Resolution or resolution of issuance governing such Veterans General Obligation Bonds, respectively, the Trustee shall establish a Series Proceeds Subaccount and a Series Recycling Subaccount within the Proceeds Account applicable to such Series of Bonds or series of Veterans General Obligation Bonds. The Trustee shall deposit amounts received in connection with the issuance of Bonds or Veterans General Obligation Bonds into the Proceeds Account or any such Subaccount in the amount(s) and at the time(s) set forth in the Series Resolution or resolution of issuance, respectively, authorizing the issuance thereof. Amounts shall also be deposited in the Proceeds Account from a transfer of funds from the Revenue Account pursuant to the provisions of Section 403(c)(11) of the Resolution. Amounts on deposit in the Proceeds Account may be transferred between various Series Proceeds Subaccounts and Series Recycling Subaccounts, as set forth in the Program Operating Procedures.

(b) Moneys in the Proceeds Account shall be withdrawn or transferred therefrom in accordance with law upon requisition of the Department for the purpose of carrying out the provisions of the Bond Act and the Program Acts, including by entering into Contracts of Purchase, and by paying administrative expenses of the Department, including Costs of Issuance.

(c) The Trustee shall transfer from the Proceeds Account any amount specified by the Department from time to time in a Department Request for the purpose of redeeming or purchasing Bonds or Veterans G.O. Bonds or for the purpose of funding the Bond Reserve Account as provided in the applicable Series Resolution and Program Operating Procedures.

(d) The Trustee shall transfer any amount deposited in a Series Recycling Subaccount to the related Series Restricted Recoveries Subaccount or to the related Series Revenue Subaccount, upon a Department Request in the amount and at the time(s) stated in such Department Request.

(e) Moneys held for the credit of the Proceeds Account shall be transferred to be applied for payment of Bonds or Veterans General Obligation Bonds pursuant to Section 410 of the Resolution.

**Revenue Account; Application of Revenues (Section 403)**

(a) The Department shall transfer all Revenues to the Trustee for deposit in the Revenue Account upon the Department's identification and receipt thereof. Upon transfer, the Department shall identify the amount of Restricted Recoveries included in such Revenues and deposit the same, unless otherwise provided in the applicable Series Resolution or any resolution of issuance governing a series of Veterans General Obligation Bonds, in the related Series Restricted Recoveries Subaccount. The balance shall be deposited in the related Series Revenue Subaccount.

(b) Pursuant to a Department Request, based on the Department's determination that certain Revenues previously deposited in a Series Revenue Subaccount constitute Restricted Recoveries, the Trustee shall transfer Revenues in an amount equal to and representing such Restricted Recoveries from the Series Revenue Subaccount to the related Series Restricted Recoveries Subaccount (if any).

(c) From time to time as required or as otherwise directed by Department Request, the Department shall cause to be transferred, applied, or retained all Revenues in the Revenue Account (not including Series Restricted Recoveries Subaccounts, which shall be governed by Section 409 of the Resolution) for the following purposes (subject, in the case of any deficiency in available Revenues to meet the requirements of one or more of clauses (1) through (6), to the provisions as to deficiency contained in Section 410):

(1) In accordance with the applicable Series Resolution to transfer to any Rebate Account, or otherwise to the U.S. Treasury, the amount(s) if any, specified by Department Request;

(2) From the GO Bond Series Revenue Subaccounts, to reimburse the General Fund for amounts previously paid out of the General Fund (and not previously reimbursed pursuant to this provision) for principal of and interest on the Veterans General Obligation Bonds of the related series (together with interest at the same rate as borne by said bonds, compounded semiannually, from the due date of such principal and interest to the date of such reimbursement);

(3) From the GO Bond Series Revenue Subaccounts, to transfer to the General Fund the amount of the principal of and interest then due on the Veterans General Obligation Bonds of the related series and the amount of Credit and Liquidity Support Expenses then due and related thereto;

(4) From the Revenue Bond Series Revenue Subaccounts, to pay interest due on the Bonds of the related Series;

(5) From the Revenue Bond Series Revenue Subaccounts, to pay principal (including by operation of Mandatory Sinking Account Payments) due on the Bonds of the related Series;

(6) From the Revenue Bond Series Revenue Subaccounts, to pay any Credit and Liquidity Support Expenses then due and related to the Bonds of the related Series;

(7) From the Revenue Bond Series Revenue Subaccounts, upon Department Request and (without Department Request) at least once every month, to deposit to the credit of the Bond Reserve Account an amount sufficient to cause the amount on deposit in said Account to equal the Bond Reserve Requirement (to be allocated among any Revenue Bond Series Bond Reserve Subaccounts in accordance with the Program Operating Procedures);



(8) From the Revenue Bond Series Revenue Subaccounts, pursuant to the terms of a Series Resolution upon the issuance of a Series of Bonds, to transfer such amount as is required to cause the amount in the Loan Loss Account to equal the Loan Loss Requirement;

(9) From all Series Revenue Subaccounts pursuant to Program Operating Procedures to transfer an amount to the Department for deposit to any operating or other account, free and clear of the lien of the Resolution, equal to Expenses specified in a Department Request as contemplated by the Program Operating Procedures;

(10) From the GO Bond Series Revenue Subaccounts, on the first day of each month, to accumulate in the GO Bond Series Revenue Subaccounts collectively (in such respective allocations made at such times as are required by the Program Operating Procedures), an amount equal to Accrued Debt Service on the Veterans General Obligation Bonds of all series;

(11) From any Series Revenue Subaccount, upon Department Request, to transfer amounts for credit to the related Series Recycling Subaccount; and

(12) With respect to amounts constituting Excess Revenues or Restricted Recoveries, to redeem any Series of Bonds or series of Veterans General Obligation Bonds upon Department Request and in accordance with the provisions of a Series Resolution or Supplemental Resolution, or resolution of issuance governing such Veterans General Obligation Bonds, respectively.

(d) Revenues in the Revenue Account shall be applied to the purchase of Bonds at the times, in the manner and for the purposes set forth in Section 406 of the Resolution.

(e) Amounts on deposit in the Revenue Account upon Department Request may be transferred between any Series Restricted Recoveries Subaccount or Series Revenue Subaccount and any other Series Restricted Recoveries Subaccount or Series Revenue Subaccount, as set forth in the Program Operating Procedures.

#### **Interest (Section 404)**

In payment of interest on Bonds, the Trustee shall remit (or other method of transfer acceptable to the Department and to any Securities Depository) (i) by mail to each owner of Bonds the amounts required for paying the interest on such Bonds as such interest becomes due and payable and (ii) payment for any Credit and Liquidity Support Expenses relating to such Bonds as described in Section 403(c)(6) of the Resolution. An Authorized Representative of the Department shall advise the Trustee regarding the amount of any such Credit and Liquidity Support Expenses and when payment is due.

#### **Principal (Section 405)**

(a) *Principal Payments.* The Trustee shall set aside in the Revenue Account for remittance to Bondowners the amounts required for paying the principal of all Bonds as such principal becomes due and payable.

(b) *Mandatory Sinking Account Payments Redemption.* Amounts on deposit in any Revenue Bond Series Revenue Subaccount prior to being applied in satisfaction of Mandatory Sinking Account Payments shall be applied as applicable to the purchase of Term Bonds of the related Series then Outstanding subject to Mandatory Sinking Account Payments on the next date such payments are scheduled as provided in this paragraph. The Trustee, upon direction of an Authorized Representative, shall endeavor to purchase the Term Bonds or portions of Term Bonds of each Series stated to mature on the next maturity date or to be redeemed pursuant to Mandatory Sinking Account Payments for Term Bonds of such Series then Outstanding at a price not to

exceed the Redemption Price (plus accrued interest to the date of redemption) which would be payable on the next redemption date to the Owners of such Term Bonds under the provisions of the applicable Series Resolution if such Term Bonds or portions of Term Bonds should be called for redemption on such date. Provided, however, that, subject to applicable law, notwithstanding the maximum purchase price set forth in the preceding sentence, if at any time the investment earnings on the moneys in the Revenue Account equal to the Mandatory Sinking Account Payments for the next date such payments are scheduled shall be less than the interest accruing on the Bonds to be redeemed on such date from such Mandatory Sinking Account Payments, then the Trustee may pay a purchase price for any such Bond in excess of the Redemption Price which would be payable on the next redemption date to the owner of such Bond under the provisions of the applicable Series Resolution, if an Authorized Representative certifies to the Trustee that the amount paid in excess of said Redemption Price is expected to be less than the interest which is expected to accrue on said Bond less any investment earnings on such available moneys during the period from the settlement date of the proposed purchase to the redemption date. The Trustee shall pay the interest accrued on such Term Bonds or portions of Term Bonds to the date of settlement therefor from the Revenue Account. Notwithstanding the foregoing, no such purchase shall be made by the Trustee after the giving of notice of redemption by the Trustee.

(c) Any purchase or redemption of Bonds shall be made pursuant to the provisions of Article III of the Resolution. Upon retirement of any Term Bonds by purchase or redemption pursuant to the provisions of Section 405 of the Resolution, the Trustee shall file with the Department a statement identifying such Bonds and setting forth the date of their purchase or redemption, the amount of the purchase price or the Redemption Price of such Bonds and the amount paid as interest thereon. The expenses in connection with the purchase or redemption of any such Bonds shall be paid by the Trustee from any moneys available therefor in the Revenue Account.

#### **Redemption (Section 406)**

(a) The Trustee shall apply all amounts in Revenue Bond Series Restricted Recoveries Subaccounts, and all moneys otherwise set aside in the Revenue Account for the redemption of Bonds pursuant to Section 403(c)(12) of the Resolution, to the purchase or redemption of Bonds issued under the provisions of the Resolution, as follows:

(1) The Trustee, upon direction of an Authorized Representative, shall endeavor to purchase Bonds or portions of Bonds then Outstanding, whether or not such Bonds or portions of Bonds shall then be subject to redemption, at a price not to exceed the Redemption Price (plus accrued interest, if any, to the date of redemption) which would be payable on the next redemption date to the owners of such Bonds if such Bonds or portions of Bonds should be called for redemption on such date from the moneys in the respective Account. Such maximum purchase price may be exceeded in accordance with the proviso in Section 405(b) of the Resolution. The Trustee shall pay the interest accrued on such Bonds to the date of settlement therefor from the Revenue Account, but no such purchase shall be contracted for by the Trustee after the giving of notice by the Trustee that such Bonds have been called for redemption except from moneys other than the moneys set aside for the redemption of such Bonds.

(2) The Trustee, having endeavored to purchase Bonds pursuant to subsection (1) of this subsection (a), shall call for redemption, on the earliest practicable date on which Bonds are subject to redemption from such moneys, such amount (computed on the basis of Redemption Prices) of Bonds as will exhaust the moneys set aside for such redemption, as nearly as may be practicable.

(b) Any purchase or redemption of Bonds shall be made pursuant to the provisions of Article III of the Resolution. Prior to calling Bonds or portions of Bonds for redemption, the Trustee shall

set aside the respective amounts required for paying the interest on and the Redemption Price of the Bonds or portions of Bonds so called for redemption. Upon the retirement of any Bonds under Section 406 of the Resolution by purchase or redemption, the Trustee shall file with the Department a statement briefly describing such Bonds and setting forth the date of their purchase or redemption, the amount of the purchase price or the Redemption Price of such Bonds and the amount paid as interest thereon. The expenses in connection with the purchase or redemption of any such Bonds shall be paid by the Trustee from any moneys available therefor in the Revenue Account.

#### **Bond Reserve Account (Section 407)**

(a) Moneys held for the credit of the Bond Reserve Account shall be transferred by the Trustee to be applied for payment of Bonds pursuant to Section 410 of the Resolution.

(b) Moneys held for the credit of the Bond Reserve Account as of any date in excess of the Bond Reserve Requirement upon Department Request shall be transferred to the Loan Loss Account, the Revenue Account or the Proceeds Account.

(c) A Series Resolution may provide that the Bond Reserve Requirement with respect to the applicable Series of Bonds may be funded through Cash Equivalents. In connection with any discussion in the Resolution of "moneys" on deposit in or held for the credit of the Bond Reserve Account, "moneys" shall be deemed to include said Cash Equivalents.

(d) Upon Department Request, the Trustee shall transfer an amount required to cause the Bond Reserve Account to equal the Bond Reserve Requirement from available amounts in the 1943 Fund.

#### **Loan Loss Account (Section 408)**

(a) Pursuant to the Program Operating Procedures, moneys held for the credit of the Loan Loss Account as of any date upon Department Request shall be transferred to the Revenue Account, the Bond Reserve Account, the Proceeds Account or any GO Bond Series Revenue Subaccount.

(b) A Series Resolution may provide that the Loan Loss Requirement with respect to the applicable Series of Bonds may be funded through Cash Equivalents. In connection with any discussion in the Resolution of "moneys" on deposit in or held for the credit of the Loan Loss Account, "moneys" shall be deemed to include said Cash Equivalents.

(c) Moneys held for the credit of the Loan Loss Account shall be transferred by the Trustee to be applied for payment of Bonds, pursuant to Section 410 of the Resolution.

(d) Upon Department Request, the Trustee shall transfer an amount required to cause the Loan Loss Account to equal the Loan Loss Requirement from available amounts in the 1943 Fund.

(e) To the extent set forth in a Department Request, the Trustee shall apply amounts in the Loan Loss Account to remedy shortfalls in recoveries on Contracts of Purchase financed by or otherwise allocable to the Veterans General Obligation Bonds of any series.

#### **Restricted Recoveries (Section 409)**

Upon the issuance of a Series of Bonds or series of Veterans General Obligation Bonds, if so required by the terms of the Series Resolution or resolution of issuance governing the Veterans General Obligation Bonds, the Trustee shall establish a Series Restricted Recoveries Subaccount within the Revenue Account applicable to such Series of Bonds or series of Veterans General Obligation Bonds. If the Trustee does not receive a Department Request with respect to a mandatory redemption from Restricted Recoveries set forth in a Series Resolution, the Trustee shall

apply Restricted Recoveries in an amount sufficient to accomplish such mandatory redemption to a redemption of Bonds (subject to any other priority set forth in the applicable Series Resolution) on a pro rata basis, as nearly as practicable, from among each maturity of the Series (and subseries, if applicable) of Bonds which financed the related Contracts of Purchase. Upon Department Request, the Trustee shall transfer amounts in any Series Restricted Recoveries Subaccount to the related Series Revenue Subaccount.

#### **Deficiencies in Debt Service (Section 410)**

In the event that amounts in the Revenue Account shall be insufficient on any interest payment date or principal payment date for the Bonds or the Veterans General Obligation Bonds to pay the principal of and interest on such Bonds, or provide for payment with respect to Veterans General Obligation Bonds pursuant to the provisions of Section 403(c)(2) or (3) of the Resolution in each case if payment is due and unpaid on such date, whether at the stated payment or maturity date or by the retirement thereof by Mandatory Sinking Account Payments (or sinking account retirement with respect to the Veterans General Obligation Bonds) therefor, the Trustee shall withdraw amounts from the following Accounts in the following order of priority to the extent necessary to eliminate such deficiency; provided, however, that no amounts shall be used for such purpose to the extent that such amounts have been set aside for the payment of Bonds or Veterans General Obligation Bonds which have been identified for purchase pursuant to Section 403 or 406 of the Resolution or called for redemption, and no amounts on deposit in the Proceeds Account shall be used for such purpose to the extent that the Department is contractually obligated to enter into Contracts of Purchase acceptable for financing with such amounts:

(a) With respect to deficiencies in payments related to Veterans General Obligation Bonds, in the following order of priority:

- (i) GO Bond Series Recycling Subaccounts;
- (ii) GO Bond Series Proceeds Subaccounts;
- (iii) GO Bond Series Restricted Recoveries Subaccounts;
- (iv) Revenue Bond Series Revenue Subaccounts;
- (v) Revenue Bond Series Recycling Subaccounts;
- (vi) Revenue Bond Series Proceeds Subaccounts; and
- (vii) Revenue Bond Series Restricted Recoveries Subaccounts.

(b) With respect to deficiencies in debt service related to Bonds, in the following order of priority:

- (i) Revenue Bond Series Recycling Subaccounts;
- (ii) Revenue Bond Series Proceeds Subaccounts;
- (iii) Revenue Bond Series Restricted Recoveries Subaccounts;
- (iv) GO Bond Series Revenue Subaccounts;
- (v) GO Bond Series Recycling Subaccounts;
- (vi) GO Bond Series Proceeds Subaccounts;
- (vii) GO Bond Series Restricted Recoveries Subaccounts;
- (viii) Loan Loss Account; and
- (ix) Bond Reserve Account.

### **Moneys Held in Trust (Section 411)**

(a) All moneys which the Trustee shall have withdrawn or set aside for the purpose of payment of any of the Bonds secured by the Resolution, either at the maturity thereof or upon call for redemption, shall be held in trust for the respective owners of such Bonds and such moneys shall not be subject to lien or attachment by any creditor of the Department or the Trustee. Any moneys which shall be so set aside by the Trustee and which shall remain unclaimed by the owners of such Bonds for the period of two (2) years after the date on which such Bonds or the interest thereon shall have become due and payable shall be paid to the Department or to such officer, board or body as may then be entitled by law to receive the same, and thereafter the owners of such Bonds shall look only to the Department or to such officer, board or body, as the case may be, for payment and then only to the extent of the amounts so received without any interest thereon, and the Trustee shall have no responsibility with respect to such moneys.

(b) If sufficient money or Government Obligations (the principal of or interest on which will provide sufficient money for payment of the principal amount or accrued interest on the Bonds on their maturity date or each date thereafter that they become due by redemption or otherwise) are held by the Trustee in trust for the Owners of Bonds, such Bonds shall cease to be Outstanding under the provisions of the Resolution, interest on the Bonds which have matured shall cease to accrue, such Bonds shall cease to be entitled to any benefit or security under the Resolution, and the owners of such Bonds shall have no rights in respect thereof, except to receive payment of the principal amount thereof and accrued interest thereon to the maturity date. Notwithstanding any provision of the Resolution to the contrary, the Department may issue refunding Bonds to refund the liabilities remaining on any such Bonds, despite their characterization for other purposes as not Outstanding hereunder.

### **Security for Deposits (Section 501)**

All money deposited with a co-Trustee in any Account created under the Resolution shall, unless invested in Investment Obligations in accordance with Section 502 (except, to the extent applicable, the last paragraph of Section 502) of the Resolution, to the extent such deposits are in excess of the amount guaranteed by the Federal Deposit Insurance Corporation or other Federal agency, be continuously secured (if permitted by law), for the benefit of the Department and the owners of the Bonds either (a) by lodging with a bank or trust company selected by the Department as custodian, or, if then permitted by law, by setting aside under control of the trust department of the bank holding such deposit as collateral security, Government Obligations or, with the approval of the Department, other marketable securities eligible as security for the deposit of trust funds under regulations of the Comptroller of the Currency of the United States of America, having a market value at all times (exclusive of accrued interest) not less than the amount of such deposit, or (b) if the furnishing of security as provided in clause (a) of Section 501 of the Resolution is not permitted by applicable law, then in such other manner as may then be required or permitted by applicable State or Federal laws and regulations regarding the security for, or granting a preference in the case of, the deposit of trust funds; provided, however, that it shall not be necessary, except as otherwise expressly provided, for the Trustee to give security for any money which shall be represented by obligations purchased under the provisions of Article V of the Resolution as an investment of such money.

### **Investment of Moneys (Section 502)**

The Revenue Bond Series Proceeds Subaccounts, Series Recycling Subaccounts, Series Restricted Recoveries Subaccounts, Series Revenue Subaccounts, Loan Loss Account and Bond Reserve Account shall, as nearly as is practicable, be fully and continuously invested or reinvested in Investment Obligations.

**Covenant Against Encumbrances (Section 605)**

The Department covenants that, except as expressly permitted in the Resolution, it will not sell, convey, mortgage, encumber or otherwise dispose of the money held for the credit of any Account created under the Resolution except the pledge created by the Resolution and any interest or right to which such pledge is by its terms secondary and subordinate or take any other action which would adversely affect the security of the Bondowners stated in the Resolution.

**Program Operating Procedures (Section 606)**

(a) The Department shall have on file with the Trustee at all times during which Bonds are Outstanding current Program Operating Procedures accompanied by a Counsel's Opinion that the same are consistent with the provisions of the Resolution.

(b) Upon adoption of Program Operating Procedures, the Department shall thereafter administer the Program and perform its obligations under the Resolution in accordance in all material respects with the Program Operating Procedures. Any action taken by the Department with respect to Contracts of Purchase, Bonds and Pledged Property shall be deemed a representation and warranty by the Department under the Resolution that such action is in conformance with any provision of the current Program Operating Procedures applicable thereto.

(c) The Program Operating Procedures may be amended only if (1) a Cash Flow Statement is delivered to the Trustee, and (2) an opinion of nationally recognized bond counsel is delivered to the Trustee to the effect that such amendment or action taken pursuant to such amendment will not affect the exemption of interest on the Bonds from the gross income of the holders thereof for federal income tax purposes.

**Cash Flow Statements (Section 607)**

(a) The Department shall file with the Trustee a current Cash Flow Statement (i) upon adoption of each Series Resolution and each Supplemental Resolution; (ii) upon issuance of any series of Veterans General Obligation Bonds; (iii) when required pursuant to any Series Resolution or Supplemental Resolution; (iv) upon any change in the Program Operating Procedures; and (v) whenever required pursuant to the provisions of Section 608 of the Resolution. The Department may file a new or amended Cash Flow Statement conforming to the requirements of Section 607 of the Resolution at any time. Any Cash Flow Statement shall be the subject of a Rating Confirmation if it does not include all the scenarios included in the Cash Flow Statement previously on file with the Trustee.

(b) A Cash Flow Statement shall consist of a Certificate of the Department containing the conclusion of an Authorized Representative of the Department that projected Revenues will be sufficient to provide for timely payments of interest and principal on the Bonds and Expenses, under each of the scenarios included in the cash flow projections attached to the Resolution. The Cash Flow Statement shall include each scenario included in the immediately prior Cash Flow Statement except as may be required by any Rating Agency in connection with a Rating Confirmation. A Cash Flow Statement shall (i) take into account the financial position of the 1943 Fund, the Bond Reserve Account and the Loan Loss Account as of the stated starting date of the projection, (ii) reflect all the significant transactions that have occurred in the period commencing with such starting date and ending with a date no more than ninety (90) days prior to the date of such projections, (iii) be consistent with the Resolution and (iv) assume compliance with the Program Operating Procedures.

(c) The Cash Flow Statement shall set forth for each scenario included therein the sets of assumptions on which it is based including, without limitation, the following:

(i) the timing and terms of issuance or remarketing of Bonds and Veterans General Obligation Bonds;

(ii) the timing of the acquisition of Contracts of Purchase and the interest rates thereon and maturities thereof;

(iii) the timing and amounts of the receipt of payments of scheduled principal or and interest on Contracts of Purchase;

(iv) the timing and amounts of prepayments on Contracts of Purchase;

(v) the timing and amount of defaults on Contracts of Purchase and disposition or recovery prices of defaulted Contracts of Purchase, which assumption may be based on a specified model of default frequency and loss severity as a function of Contract of Purchase portfolio characteristics;

(vi) the investment return on Accounts and subaccounts, to the extent that amounts on deposit will not be subject to an investment agreement;

(vii) the performance by the Department's counterparty with respect to obligations under an enhancement agreement or arrangement for Supplemental Contract of Purchase Coverage or investment of funds;

(viii) the types of Primary Contract of Purchase Coverage and Supplemental Contract of Purchase Coverage; and

(ix) the Loan Loss Requirement.

(d) If any Cash Flow Statement shall show that projected Revenues shall be insufficient to provide for timely payments of interest on and principal of the Bonds and Expenses, the Department shall not be in default under the Resolution but shall take all reasonable actions to eliminate such deficiency. The Department shall be precluded from taking the actions described or referenced in clauses (i) through (iv) of subsection (a) of the first paragraph of this section if the Cash Flow Statement on file with the Trustee in accordance with the requirements of the first paragraph of this Section Cash Flow Statements shall show that the taking of such action shall cause a deficiency to occur or shall increase any existing deficiency.

#### **Maintenance of Fund Parity (Section 608)**

The Department shall cause a calculation to be made of Fund Parity, as evidenced in a Certificate of the Department filed with the Trustee as of the last day of each Fiscal Year (and upon receipt of the audited financial statements of the 1943 Fund), or more frequently in the discretion of the Department. If any such calculation shall not reflect that Fund Parity at least equals the Applicable Fund Parity Percentage (provided that any Applicable Fund Parity Percentage which is less than 50% shall be the subject of a Rating Confirmation) of the then Outstanding aggregate principal amount of Bonds, all Excess Revenues shall thereafter be applied to redeem Bonds of the Series and in the manner reflected in the current Cash Flow Statement until (and if) the Department files with the Trustee a new Certificate of the Department reflecting a calculation of Fund Parity that at least equals such 50% (or such other percentage) level; provided, however, that no such Cash Flow Statement and no such redemption shall be required under the Resolution if the Department shall have provided a Rating Confirmation to the Trustee. But see "SECURITY AND SOURCES OF PAYMENT OF THE REVENUE BONDS—Maintenance of Fund Parity" for the current percentage.

**Tax Covenants (Section 609)**

The Department shall at all times perform the applicable tax covenants contained in any applicable Series Resolution. In addition, the Department shall not amend the interest rates on any existing Contracts of Purchase unless the Department shall have provided the Trustee with an opinion of nationally recognized bond counsel to the effect that such action will not impair any exclusion of interest on the Bonds issued with the intent that such interest be excluded from gross income for federal income tax purposes.

**Books and Records (Section 611)**

(a) The Trustee shall keep proper books of record and account in which complete and correct entries shall be made of all transactions relating to the receipts, disbursements, allocations and applications of all moneys received by the Trustee under the Resolution, and such books shall be available for inspection by the Department and any Bondowner during business hours, upon reasonable notice and under reasonable conditions.

(b) The Department shall keep proper books of records and account for all its transactions, other than those recorded in the books maintained by the Trustee pursuant to subsection (a) of Section 611 of the Resolution, and such books shall be available for inspection by the Trustee and any Bondowner during business hours and upon reasonable notice.

**Annual Audit, Report and No-Default Certificate (Section 612)**

By the first day of the tenth month after the end of each Fiscal Year, the Department shall furnish to the Trustee (i) a statement of the revenues and expenses and of the changes in the fund balances during the previous Fiscal Year, in each case with respect to the 1943 Fund, the Bond Reserve Account and the Loan Loss Account, certified to by an Accountant, and (ii) a certificate from an Authorized Representative stating that there is no current Event of Default and that no Event of Default occurred during the preceding Fiscal Year (or if there has been an Event of Default, providing the details of the Resolution and describing the steps the Department took, or is taking, to cure such Event of Default).

**Program Covenants (Section 614)**

The Department shall from time to time, with all practical dispatch and in a sound and economical manner consistent in all respects with the Bond Act, the Program Acts, the Resolution and all other applicable laws and regulations and with sound banking practices and principles, use and apply the amounts held in the 1943 Fund and available therefor to the financing of Contracts of Purchase and to other uses permitted under the Resolution and the law, and shall take all steps, actions and proceedings reasonable and necessary in the judgment of the Department to enforce the terms, covenants and conditions of each Contract of Purchase.

**Issuance of Additional Obligations and Subordinate Obligations (Section 615)**

The Department, so long as any Bonds shall be Outstanding under the Resolution, shall not issue any bonds, notes or other evidences of indebtedness, other than the Bonds, secured by any pledge of or other lien or charge on the Pledged Property nor shall the Department create or cause to be created any lien or charge on the Pledged Property, other than the lien and pledge created under the Resolution and other than the rights of the State or the holders of the Veterans General Obligation Bonds. Nothing contained in Section 615 of the Resolution shall prevent the Department from issuing any bonds, notes or other evidences of indebtedness which are payable from or secured by a lien and pledge on the Pledged Property provided that payment of such evidences of indebtedness and such lien and pledge shall be in all respects subordinate to the provisions of the



Resolution and the lien and pledge created by the Resolution and any such evidences of indebtedness shall contain an appropriate recital with respect to such subordination.

**Events of Default Defined (Section 702)**

Each of the following events is by the Resolution declared an "Event of Default", that is to say: If

(a) payment of the principal or Redemption Price of any of the Bonds shall not be made when the same shall become due and payable, either at maturity or by proceedings for redemption or otherwise; or

(b) payment of any installment of interest on any of the Bonds shall not be made when the same shall become due and payable; or

(c) the entry of a decree or order for relief by a court having jurisdiction in the premises in respect of the Department in an involuntary case under the Federal bankruptcy laws, as now or under the Resolution constituted, or any other applicable Federal or State bankruptcy, insolvency or other similar law, or appointing a receiver, liquidator, assignee, custodian, trustee, sequestrator (or similar official) of the Department or for any substantial part of its property, or ordering the winding-up or liquidation of its affairs and the continuance of any such decree or order unstayed and in effect for the period of 60 consecutive days; or

(d) the commencement by the Department of a voluntary case under the Federal bankruptcy laws, as constituted under the Resolution or hereafter amended, or any other applicable Federal or State bankruptcy, insolvency or other similar law, or the consent by it to the appointment of or taking possession by a receiver, liquidator, assignee, trustee, custodian, sequestrator (or other similar official) of the Department or for any substantial part of its property or the making by it of any assignment for the benefit of creditors, or the taking of action by the Department in furtherance of any of the events under Section 702 of the Resolution; or

(e) failure by the Department to pay, when due or within any applicable grace period, any amount owing on account of indebtedness for money borrowed or for deferred purchases of property, or the failure by the Department to observe or perform any covenant or undertaking on its part to be observed or performed in any agreement evidencing, securing or relating to such indebtedness, resulting, in any such case, in an event of default or acceleration by the holder of such indebtedness of the date on which such indebtedness would otherwise be due and payable; or

(f) the Department defaults in the due and punctual performance of any other covenants or agreements contained in the Bonds or in the Resolution and such default continues for 90 days after written notice requiring the same to be remedied shall have been given to the Department by the Trustee, which may give such notice in its discretion and shall give such notice at the written request of the owners of not less than twenty per centum (20%) in aggregate principal amount of Bonds then Outstanding; provided, however, that so long as following such notice the Department is diligently taking actions to remedy such default, such default shall not be an Event of Default.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including 1998 Series A Bonds) Outstanding under the Resolution, Ambac Assurance Corporation (the "1998 Series A Insurer"), as the provider of the 1998 Series A Municipal Bond Insurance Policy, will be deemed to be the owner of the 1998 Series A Bonds which it insures. See "The 1998 Series A Insurer Treated as Bondowner for Certain Actions."

#### **Enforcement of Remedies (Section 704)**

Upon the happening and continuance of any Event of Default specified in Section 702 of the Resolution, then and in every such case the Trustee may, and upon the written direction of the owners of not less than twenty per centum (20%) in aggregate principal amount of the Bonds then Outstanding under the Resolution shall, proceed, subject to the provisions of Section 802 of the Resolution, to protect and enforce its rights and the rights of the Bondowners under applicable laws or under the Resolution by such suits, actions or special proceedings in equity or at law, or by proceedings in the office of any board or officer having jurisdiction, either for the specific performance of any covenant or agreement contained in the Resolution or in aid or execution of any power in the Resolution granted or for the enforcement of any proper legal or equitable remedy, as the Trustee, being advised by counsel, shall deem most effectual to protect and enforce such rights.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including 1998 Series A Bonds) Outstanding under the Resolution, the 1998 Series A Insurer, as the provider of the 1998 Series A Municipal Bond Insurance Policy, will be deemed to be the owner of the 1998 Series A Bonds which it insures. See "The 1998 Series A Insurer Treated as Bondowner for Certain Actions."

#### **Pro Rata Application of Funds (Section 706)**

Anything in the Resolution to the contrary notwithstanding, if at any time the money in the Accounts maintained under the Resolution (other than any Rebate Account) shall not be sufficient to pay the principal of or interest on the Bonds as the same shall become due and payable such money, together with all amounts then on deposit in the 1943 Fund other than Veterans General Obligation Bonds proceeds, together with any money then available or thereafter becoming available for such purpose, whether through the exercise of the remedies provided for in the Article or otherwise, shall be applied, following the satisfaction of any payments due to the Trustee under the provisions of Section 802 and 805 of the Resolution, as follows:

(a) Except in the case of amounts on deposit in the Bond Reserve Account and the Loan Loss Account and interest, profit or other income derived from the investment of such amounts, for transfer to the General Fund in the State Treasury in accordance with and at the times stated in Sections 403(c)(2) and (3) of the Resolution.

(b) After application pursuant to clause (a) of Section 706 of the Resolution, all such money shall be applied:

*first:* to the payment to the persons entitled thereto of all installments of interest on Bonds (except interest on overdue principal) then accrued and unpaid in the chronological order in which such installments of interest accrued and, if the amount available shall not be sufficient to pay in full any particular daily installment, then to the payment, ratably, according to the amounts due on such daily installment, to the persons entitled thereto as owners of Bonds, without any discrimination or preference except as to any difference in the respective rates of interest specified in the Bonds;

*second:* to the payment to the persons entitled thereto of the unpaid principal of any of the Bonds which shall have become due and payable (except Bonds called for redemption for the payment of which, money is held pursuant to the provisions of the Resolution) in the order of their stated payment dates, with interest on the principal amount of such Bonds at the respective rates specified in the Resolution from the respective dates upon which such Bonds became due and payable, and, if the amount available shall not be sufficient to pay in full the principal of the Bonds by their stated terms due and payable

on any particular date, together with such interest, then to the payment first of such interest, ratably, according to the amount of such interest due on such date, with such payment being made to owners of Bonds, and then to the payment of such principal, ratably, according to the amount of such principal due on such date, to the persons entitled thereto as owners of Bonds, without any discrimination or preference except as to any difference in the respective rates of interest specified in the Bonds;

*third:* to the payment of the interest on and the principal of the Bonds, to the purchase and retirement of Bonds and to the redemption of the Bonds, all in accordance with the provisions of Article III of the Resolution.

The provisions of subsection (a) of Section 706 of the Resolution are in all respects subject to the provisions of Section 701 of the Resolution.

(c) Whenever money is to be applied by the Trustee pursuant to the provisions of Section 706 of the Resolution, such money shall be applied by the Trustee at such times, and from time to time, as the Trustee in its sole discretion shall determine, having due regard to the amount of such money available for application and the likelihood of additional money becoming available for such application in the future; the deposit of such money with any paying agent, or otherwise setting aside such money, in trust for the proper purpose shall constitute proper application by the Trustee; and the Trustee shall incur no liability whatsoever to the Department, to any Bondowner or to any other person for any delay in applying any such money, so long as the Trustee acts with reasonable diligence, having due regard to the circumstances, and ultimately applies the same in accordance with such provisions of the Resolution as may be applicable at the time of application by the Trustee. Whenever the Trustee shall exercise such discretion in applying such money, it shall fix the date (which shall be an interest payment date unless the Trustee shall deem another date more suitable) upon which such application is to be made and upon such date interest on the amounts of principal to be paid on such date shall cease to accrue. The Trustee shall give such notice as it may deem appropriate of the fixing of any such date, and shall not be required to make payment to the owner of any Bond until such Bond shall be surrendered to the Trustee for appropriate endorsement, or for cancellation if fully paid.

#### **Owners of Majority in Principal Amount of Bonds May Control Proceedings (Section 708)**

Anything in the Resolution to the contrary notwithstanding, the owners of a majority in principal amount of the Bonds then Outstanding under the Resolution shall have the right, subject to the provisions of Section 802 of the Resolution, by an instrument or concurrent instruments in writing executed and delivered to the Trustee, to direct the method and place of conducting all remedial proceedings to be taken by the Trustee under the Resolution or exercising any trust or power conferred upon the Trustee, provided that such direction shall not be otherwise than in accordance with law and the provisions of the Resolution, and the Act and, in the sole judgment of the Trustee, is not unduly prejudicial to the interests of Bondowners not joining in such direction and provided, further, that nothing in Section 708 of the Resolution shall impair the right of the Trustee in its discretion to take any other action under the Resolution which it may deem proper and which is not inconsistent with such direction by Bondowners.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including 1998 Series A Bonds) Outstanding under the Resolution, the 1998 Series A Insurer, as the provider of the 1998 Series A Municipal Bond Insurance Policy, will be deemed to be the owner of the 1998 Series A Bonds which it insures. See "The 1998 Series A Insurer Treated as Bondowner for Certain Actions."

### **Restrictions Upon Actions by Individual Bondowner (Section 709)**

No owner of any of the Bonds shall have any right to institute any suit, action or proceeding in equity or at law on any Bond or for the execution of any trust under the Resolution or for the enforcement of any remedy under the Resolution unless such owner previously shall have given to the Trustee written notice of the Event of Default on account of which such suit, action or proceeding is to be instituted, and unless also the owners of not less than fifteen per centum (15%) in aggregate principal amount of the Bonds then Outstanding shall have made written request of the Trustee after the right to exercise such powers or right of action, as the case may be, shall have accrued, and shall have afforded the Trustee a reasonable opportunity either to proceed to exercise the powers granted in the Resolution or to institute such action, suit or proceeding in its or their name, and unless, also, there shall have been offered to the Trustee reasonable security and indemnity against the costs, expenses and liabilities to be incurred therein or by the Resolution, and the Trustee shall have refused or neglected to comply with such request within a reasonable time; and such notification, request and offer of indemnity are by the Resolution declared in every such case, at the option of the Trustee, to be conditions precedent to the execution of the powers and trusts of the Resolution or to any other remedy under the Resolution; provided, however, that notwithstanding the foregoing provisions of Section 709 of the Resolution and without complying with the Resolution, the owners of not less than twenty per centum (20%) in aggregate principal amount of the Bonds then Outstanding may institute any such suit, action or proceeding in their own names for the benefit of all owners of Bonds under the Resolution. It is understood and intended that, except as otherwise provided in the Resolution, no one or more owners of the Bonds by the Resolution secured shall have any right in any manner whatever by his or their action to affect, disturb or prejudice the security of the Resolution, or to enforce any right under the Resolution except in the manner in the Resolution provided, that all suits, actions and proceedings at law or in equity shall be instituted, had and maintained in the manner provided in the Resolution and for the benefit of all owners of such Outstanding Bonds, and that any individual right of action or other right given to one or more of such owners by law is restricted by the Resolution to the rights and remedies provided in the Resolution.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including 1998 Series A Bonds) Outstanding under the Resolution, the 1998 Series A Insurer, as the provider of the 1998 Series A Municipal Bond Insurance Policy, will be deemed to be the owner of the 1998 Series A Bonds which it insures. See "The 1998 Series A Insurer Treated as Bondowner for Certain Actions."

### **Waiver of Defaults (Section 713)**

The Trustee may, and upon written direction of the owners of not less than a majority in aggregate principal amount of the Bonds then Outstanding shall, waive any default which in their opinion shall have been remedied before the entry of final judgment or decree in any suit, action or proceeding instituted by them under the provisions of the Resolution or before the completion of the enforcement of any other remedy under the Resolution, but no such waiver shall extend to or affect any other existing or any subsequent default or defaults or impair any rights or remedies consequent thereon.

### **Notice of an Event of Default (Section 714)**

The Trustee shall mail to the Department and to all Bondowners, written notice of the occurrence of any Event of Default set forth in Section 702 of Article VII of the Resolution within thirty (30) days after the Trustee shall have received written notice thereof from the Department, subject to the provisions of Section 708 of the Resolution, that any such Event of Default shall have occurred. The Trustee shall not, however, be subject to any liability to any Bondowner by reason of a failure to mail any such notice.

### **Acceptance of Trusts (Section 801)**

(a) The Treasurer of the State shall act as trustee for the Department and the owners of the Bonds to receive and disburse all Revenues and other moneys applicable to the payment of the principal of or interest on the Bonds, including moneys in the 1943 Fund and the Veterans Debenture Fund, and otherwise to hold all the offices and to perform all the functions and duties provided in the Resolution to be held and performed by the Trustee, including acting as Bond Registrar pursuant to Section 208 of the Resolution. For purposes of Article VIII of the Resolution only, the term "Trustee" does not include any co-Trustee appointed pursuant to Section 801 of the Resolution.

(b) Upon the occurrence and continuance of an Event of Default, the Department shall, upon the request of the Trustee or of the owners of twenty percent (20%) in aggregate principal amount of the Bonds at the time outstanding, appoint a co-Trustee to represent and enforce the rights of the owners of the Bonds during the continuance of such or any other concurrent Event of Default.

(c) The Trustee shall, prior to an Event of Default, and after the curing of all Events of Default which may have occurred, perform such duties and only such duties as are specifically set forth in the Resolution. The Trustee and the co-Trustee shall, during the continuance of any Event of Default (which has not been cured), exercise such of the rights and powers vested in the Trustee and co-Trustee by the Resolution, and use the same degree of care and skill in their exercise, as a prudent person would exercise or use under the circumstances in the conduct of such person's own affairs.

(d) The Department may at any time or from time to time appoint one or more Paying Agents, in addition to the Trustee and the co-Trustee, for the purpose of paying the principal or Redemption Price of and the interest on the Bonds of any Series. Each Paying Agent shall signify its acceptance of the duties and obligations imposed on it by the Resolution by executing and delivering to the Department and to the Trustee a written acceptance of the Resolution. The Department may remove any Paying Agent at any time by giving written notice of such removal to such Paying Agent and to the Trustee. Any Paying Agent may at any time resign by giving notice of such resignation to the Department. In the event of the resignation or removal of any Paying Agent, such Paying Agent shall pay over, transfer, assign and deliver any moneys held by it to its successor or, if there be no successor then appointed, to the Trustee. The Department shall give prompt notice to Bondowners of the acceptance of appointment by any successor Paying Agent.

### **Trustee or Co-Trustee Entitled to Indemnity (Section 802)**

The Trustee or co-Trustee shall be under no obligation to institute any suit, or to take any remedial proceeding under the Resolution, or to enter any appearance or in any way defend in any suit in which it may be named as a defendant, or to take any steps in the execution of the trusts created by the Resolution or in the enforcement of any rights and powers under the Resolution, until it shall be indemnified to its satisfaction against any and all costs and expenses, outlays and counsel fees and other reasonable disbursements, and against all liability; the Trustee or co-Trustee may, nevertheless, begin suit, or appear in and defend suit, or do anything else in its judgment proper to be done by it as such Trustee or co-Trustee, without indemnity, and in such case the Department shall reimburse the Trustee or co-Trustee for all costs and expenses, outlays and counsel fees and other reasonable disbursements properly incurred in connection therewith.

### **Compensation and Indemnification of Trustee and Co-Trustee (Section 805)**

The Department shall pay, from the Pledged Property to the Trustee and co-Trustee reasonable compensation for all services performed by it under the Resolution and also all its reasonable expenses, charges and other disbursements and those of its attorneys, agents and employees

incurred in and about the administration and execution of the trusts created by the Resolution and the performance of its powers and duties under the Resolution, and from such source only, shall indemnify and save the Trustee and co-Trustee harmless against any liabilities which it may incur in the exercise and performance of its powers and duties under the Resolution.

#### **Notice of Default (Section 807)**

Except upon the happening of any Event of Default specified in clauses (a) and (b) of Section 702 of the Resolution, the Trustee or co-Trustee shall not be obliged to take notice or be deemed to have notice of any Event of Default, unless specifically notified in writing of such Event of Default by the Department or by the owners of not less than twenty per centum (20%) in aggregate principal amount of the Bonds secured by the Resolution and then Outstanding.

#### **Trustee or Co-Trustee Protected in Relying on Certain Documents (Section 810)**

The Trustee and co-Trustee shall be protected and shall incur no liabilities in acting or proceeding, or in not acting or not proceeding, in good faith, reasonably and in accordance with the terms of the Resolution, upon any resolution, order, notice, request, consent, waiver, certificate, statement, affidavit, requisition, bond or other paper or document which it shall in good faith reasonably believe to be genuine and to have been adopted or signed by the proper board or person to have been prepared and furnished pursuant to any of the provisions of the Resolution, or upon the written opinion of any attorney, engineer or accountant believed by the Trustee or co-Trustee to be qualified in relation to the subject matter, and the Trustee or co-Trustee shall be under no duty to make any investigation or inquiry as to any statement contained or matters referred to in such instrument. The Trustee or co-Trustee shall not be under any obligation to see to the recording or filing of the Resolution.

#### **Resignation and Removal of Co-Trustee Subject to Appointment of Successor (Section 811)**

No resignation or removal of the co-Trustee and no appointment of a successor co-Trustee pursuant to Article VIII of the Resolution shall become effective until the acceptance of appointment by the successor co-Trustee under Section 814 of the Resolution.

#### **Resignation of Co-Trustee (Section 812)**

Subject to Section 811 of the Resolution, the co-Trustee may resign and by the Resolution become discharged from the trusts created by the Resolution, by notice in writing to be given to the Department and mailed, first class postage prepaid, to all owners of Bonds at their addresses as they appear on the registration books kept by the Trustee, not less than sixty (60) days before such resignation is to take effect, but such resignation shall take effect immediately upon the appointment of a new co-Trustee under the Resolution, if such new Trustee or co-Trustee shall be appointed before the time limited by such notice and shall then accept the trusts of the Resolution.

#### **Removal of Co-Trustee (Section 813)**

Subject to Section 811 of the Resolution, the co-Trustee may be removed at any time by an instrument or concurrent instruments in writing executed by the Department without the consent of Bondowners or by the owners of not less than a majority in principal amount of the Bonds secured by the Resolution and then Outstanding and filed with the Department. A facsimile copy of each such instrument shall be delivered promptly by the Department to the co-Trustee. The co-Trustee may also be removed at any time for reasonable cause by any court of competent jurisdiction upon the application of the owners of not less than ten per centum (10%) in aggregate principal amount of the Bonds then Outstanding under the Resolution.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including 1998 Series A Bonds) Outstanding under the Resolution, the 1998 Series A Insurer, as the provider of the 1998 Series A Municipal Bond Insurance Policy will be deemed to be the owner of the 1998 Series A Bonds which it insures. See "The 1998 Series A Insurer Treated as Bondowner for Certain Actions."

**Appointment of Successor Co-Trustee (Section 814)**

(a) If at any time the co-Trustee shall resign, be removed, be dissolved or otherwise become incapable of acting, or the bank or trust company acting as co-Trustee shall be taken over by any governmental official, agency, department or board, the position of co-Trustee shall thereupon become vacant. If the position of co-Trustee shall become vacant for any of the foregoing reasons or for any other reason, the Department shall cause notice of such appointment to be mailed, first class postage prepaid, to all owners of Bonds at their addresses as they appear on the registration books kept by the Bond Registrar(s).

(b) At any time within one year after any such vacancy shall have occurred, the owners of a majority in principal amount of the Bonds secured by the Resolution and then Outstanding, by an instrument or concurrent instruments in writing, executed by such Bondowners and filed with the Department, may appoint a successor co-Trustee, which shall supersede any co-Trustee theretofore appointed by the Department. Facsimile copies of each such instrument shall be delivered promptly by the Department to the predecessor co-Trustee and to the co-Trustee so appointed by the Bondowners.

(c) If no appointment of a successor co-Trustee shall be made pursuant to the provisions of Section 813 of the Resolution within ten (10) days after the vacancy shall have occurred, the owner of any Bond Outstanding under the Resolution or any retiring co-Trustee may apply to any court of competent jurisdiction to appoint a successor co-Trustee. Such court may thereupon, after such notice, if any, as such court may deem proper and prescribed, appoint a successor co-Trustee.

(d) Any co-Trustee hereafter appointed shall be a bank or trust company duly qualified to do business in the State, duly authorized to exercise corporate trust powers and subject to examination by Federal or State authority, of good standing, and having at the time of its appointment a combined capital and surplus aggregating not less than Fifty Million Dollars (\$50,000,000) as shown on its most recently published report of its financial condition.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including 1998 Series A Bonds) Outstanding under the Resolution, the 1998 Series A Insurer, as the provider of the 1998 Series A Municipal Bond Insurance Policy, will be deemed to be the owner of the 1998 Series A Bonds which it insures. See "The 1998 Series A Insurer Treated as Bondowner for Certain Actions."

**No Implied Duty; Standard of Care (Section 816)**

The Trustee or co-Trustee shall have no duty or obligation except as expressly provided in the Resolution and no implied duties or obligations shall be read into the Resolution against the Trustee or co-Trustee. The Trustee or co-Trustee shall not incur any liability for any act or omission in performing its duties under the Resolution, except in the case of its own negligence or willful misconduct.

### **Bondowners' Consent Not Required (Section 1001)**

The Department may, from time to time and at any time, adopt such resolutions supplemental to the Resolution which are filed with the Trustee (which Supplemental Resolutions shall thereafter form a part of the Resolution):

- (a) to cure any ambiguity or defect or omission in the Resolution; or
- (b) to grant to or confer upon the Trustee for the benefit of the Bondowners any additional rights, remedies, powers, authority or security that may lawfully be granted to or conferred upon the Bondowners or the Trustee; or
- (c) to include as pledged revenues or money under, and subject to the provisions of, the Resolution any additional revenues or money legally available therefor; or
- (d) to make any other provisions with respect to matters or questions arising under the Resolution which shall not be inconsistent with the provisions of the Resolution, provided such action shall not materially adversely affect the interests of the Bondowners; or
- (e) to add to the covenants and agreements of the Department in the Resolution other covenants and agreements thereafter to be observed by the Department or to surrender any right or power in the Resolution reserved to or conferred upon the Department; or
- (f) to add provisions relating to Bonds with coupons appertaining thereto or Bonds issued with full book-entry delivery, if necessary, if the Department shall determine to so issue Bonds in such form under the Resolution; or
- (g) to modify any of the provisions of the Resolution in any respect whatever not otherwise set forth in the Section 1001 of the Resolution; provided, however, that either (i) such modification shall apply only to Series of Bonds issued after the effective date of the Supplemental Resolution and shall not materially adversely affect the interests of the owners of Bonds of any Series Outstanding on the effective date of the Supplemental Resolution or (ii) (a) such modification shall be, and be expressed to be, effective only after all Bonds of any Series Outstanding at the date of the adoption of such Supplemental Resolution shall cease to be Outstanding, and (b) such Supplemental Resolution shall be specifically referred to in the text of all Bonds of any Series authenticated and delivered after the date of the adoption of such Supplemental Resolution and of Bonds issued in exchange of the Resolution or in place of the Resolution; or
- (h) to modify, amend or supplement the Resolution or any Supplemental Resolution in such manner as to permit, if presented, the qualification of the Resolution and of the Supplemental Resolution under the Trust Indenture Act of 1939 or any similar Federal statute hereafter in effect or under any state Blue Sky Law; or
- (i) to surrender any right, power or privilege reserved to or conferred upon the Department by the terms of the Resolution, provided that the surrender of such right, power or privilege is not contrary to or inconsistent with the covenants and agreements of the Department contained in the Resolution; or
- (j) if the subject of a Rating Confirmation and if approved by the Trustee, to add to the definition of Investment Obligations pursuant to the last proviso of the definition in the Resolution; or
- (k) [reserved]
- (l) accompanied by a Rating Confirmation, to make any amendment or supplement necessary to accommodate credit enhancement or liquidity support for any or all Series of Bonds; or



(m) to increase the amount of the combined Bond Reserve Requirement and Loan Loss Requirement to an amount greater than ten percent (10%) of the initial principal amount of all Series of which any Bonds are Outstanding Bonds; or

(n) to amend and supplement provisions of the Resolution regarding the Trustee, and the rights of the Department and the owners of Bonds with respect to appointment and replacement of the Trustee, in the event and to the extent the laws of the State are amended to allow an institution other than the State Treasurer to act as Trustee, provided, that any such institution shall meet the qualifications set forth in Section 814(d) of the Resolution as if such institution were acting as co-Trustee under the Resolution; or

(o) to make any other change which, in the judgment of the Trustee, does not materially adversely affect the interests of the Bondowners.

**Supplements and Amendments Requiring Consent of Owners of a Majority in Principal Amount of Bonds (Section 1002)**

Subject to the terms and provisions contained in Section 1002 of the Resolution, and not otherwise, (i) the owners of not less than fifty-one per centum (51%) in aggregate principal amount of the Bonds then Outstanding; and (ii) if less than all of the Bonds then Outstanding are affected, the owners of not less than fifty-one per centum (51%) in principal amount of Bonds so affected then Outstanding, shall have the right, from time to time, anything contained in the Resolution to the contrary notwithstanding, to consent to and approve the adoption by the Department and the Trustee of such resolution or resolutions supplemental to the Resolution as shall be deemed necessary or desirable by the Department for the purpose of modifying, altering, amending, adding to, repealing or rescinding, in any particular, any of the terms or provisions contained in the Resolution or in any Supplemental Resolution. Notwithstanding the foregoing, nothing in the Resolution contained shall permit, or be construed as permitting, without the consent of all materially adversely affected Bondowners, (a) any change in the terms of redemption or of the maturity of the principal of or the interest on any Bond issued under the Resolution, or (b) a reduction in the principal amount of any Bond or the redemption premium or the rate of interest thereon, or (c) the creation of a lien upon or a pledge of the Pledged Property, or any part thereof, other than the lien and pledge created or permitted by the Resolution, or (d) a preference or priority of any Bond or Bonds over any other Bond or Bonds, except as may be permitted by the applicable Series Resolution(s), or (e) a reduction in the aggregate principal amount or classes of the Bonds required for consent to such Supplemental Resolution, or (f) an amendment or modification of the rights or obligations of the Trustee without the written consent of the Trustee. Nothing in the Resolution contained, however, shall be construed as making necessary the approval by Bondowners of the execution of any Supplemental Resolution as authorized in Section 1001, Article X of the Resolution. If any such modification or amendment will, by its terms, not take effect so long as any Bonds of any specified like Series and maturity remain Outstanding, the consent of the owners of such Bonds shall not be required and such Bonds shall not be deemed to be Outstanding for the purpose of any calculation of Outstanding Bonds under Section 1002 of the Resolution. For the purpose of Section 1002 of the Resolution, a Series shall be deemed to be affected by a modification or amendment of the Resolution or a Supplemental Resolution if the same adversely affects or diminishes the rights of the owner of Bonds of such Series. The Trustee may in its discretion determine whether or not in accordance with the foregoing powers of amendment, Bonds of any particular Series and maturity would be affected by any modification or amendment of the Resolution or a Supplemental Resolution and any such determination shall be binding and conclusive on the Department and all owners of Bonds.

Under certain circumstances in which the Resolution requires approval or consent of the owners of all or a portion of the Bonds (including 1998 Series A Bonds) Outstanding under the

Resolution, the 1998 Series A Insurer, as the provider of the 1998 Series A Municipal Bond Insurance Policy, will be deemed to be the owner of the 1998 Series A Bonds which it insures. See "The 1998 Series A Insurer Treated as Bondowner for Certain Actions."

**Defeasance (Section 1101)**

If, when the Bonds secured by the Resolution shall have become due and payable in accordance with their terms or otherwise as provided in the Resolution, or shall have been duly called for redemption or irrevocable instructions to call the Bonds for redemption shall have been given by the Department to the Trustee and (a) the whole amount of the principal of, Redemption Price, and the interest on all of such Bonds shall be paid, or (b) the Trustee shall hold money or Government Obligations or shall hold money and Government Obligations, sufficient to pay the principal of, Redemption Price, and interest on all Outstanding Bonds on their respective interest payment, stated maturity or prescribed redemption dates, provided that such Government Obligations shall be in such amount that the principal of and the interest on such Government Obligations so held by the Trustee, when due and payable, will provide sufficient money which, with any and all other money held by the Trustee for such purpose under the provisions of the Resolution, shall be sufficient to pay such principal of, Redemption Price, and the interest on such Bonds and, if sufficient funds shall also have been provided for paying all other obligations payable under the Resolution by the Department, then and in that case the right, title and interest of the Trustee under the Resolution shall thereupon cease, terminate and become void, and the Trustee in such case, on demand of the Department, shall release the Resolution and shall release the security, and shall execute such documents to evidence such release as may be reasonably required by the Department, and shall turn over to the Department or to such officer, board, or body as may then be entitled to receive the same, all the remaining property held by the Trustee under the Resolution. Otherwise, the Resolution shall be, continue and remain in full force and effect; provided, however, that in the event money or Government Obligations shall be deposited with and held by the Trustee as provided in the Resolution, applicable provisions of the Resolution, particularly Articles II, III, VII and XI, pertaining to the payment of the principal and Redemption Price of, or interest on the Bonds issued under the Resolution and other obligations payable under the Resolution by the Department, shall be continued in force until such Bonds and other obligations have been fully paid.

**The 1998 Series A Insurer Treated as Bondowner for Certain Actions**

The Ninth Supplemental Resolution provides that with respect to the 1998 Series A Bonds, during such time as: (i) the 1998 Series A Insurer is not in default under the terms and conditions of the 1998 Series A Municipal Bond Insurance Policy; and (ii) the 1998 Series A Municipal Bond Insurance Policy is in full force and effect, the Insurer will be deemed to be the owner of the 1998 Series A Bonds, (a) at all times for the purpose of the adoption of a Supplemental Resolution amending, changing or modifying the Resolution, or the initiation by Bondowners of any action to be undertaken by the Trustee at the Bondowner's request, or the removal of the co-Trustee, which under the Resolution requires the written approval or consent of the owners of all or a portion of the 1998 Series A Bonds at the time Outstanding under the Resolution or that can be initiated upon the written request of the owners of not less than all or a portion of the Bonds Outstanding under the Resolution, and (b) following an Event of Default for all other purposes.

The Ninth Supplemental Resolution further provides that the 1998 Series A Insurer will, to the extent it makes payment of principal of or interest on a 1998 Series A Bond pursuant to the 1998 Series A Municipal Bond Insurance Policy, and obtains an assignment of the 1998 Series A Bondowner's rights in, to and under the 1998 Series A Bond, as provided in the 1998 Series A Municipal Bond Insurance Policy with respect to the 1998 Series A Bonds, be subrogated to the rights of such Bondowner.

## TAX MATTERS

### Federal Tax Matters

The Offered 1999 Revenue Bonds are being issued as a single issue for certain federal income tax law purposes. The requirements of applicable federal tax law must be satisfied with respect to all of the Offered 1999 Revenue Bonds in order that interest on the Offered 1999 Revenue Bonds not be included in gross income for federal income tax purposes retroactive to the respective dates of issuance thereof. Because the Offered 1999 Revenue Bonds are treated for federal income tax purposes as refunding certain existing bonds issued to finance the Program, *except* as noted below, the requirements described below are not applicable to the New 1999 Contracts or Contracts of Purchase allocated to the Offered 1999 Revenue Bonds. Proceeds of the 1999 Series A Bonds and 1999 Series B Bonds must be used to retire outstanding bonds within ninety days of the respective issuance dates of such Revenue Bonds. Failure to so use all of such proceeds could cause interest on the Offered 1999 Revenue Bonds to be included in gross income for federal income tax purposes retroactive to their dates of issuance.

The 1997 Series C Bonds were issued pursuant to a separate plan of finance and are treated as a separate issue from the Offered 1999 Revenue Bonds for federal income tax purposes. The 1997 Series C Bonds, however, are treated as part of the same issue for certain federal income tax purposes as the Other Prior Revenue Bonds and certain previously issued Veterans G.O. Bonds (including the Series BJ Bonds) (collectively, the "1997/1998 Revenue and Veterans G.O. Bonds"). The requirements of applicable federal tax law must be satisfied with respect to the 1997/1998 Revenue and Veterans G.O. Bonds in order that interest on the 1997 Series C Bonds not be included in gross income for federal tax purposes retroactive to the date of issuance thereof. Because certain of the 1997/1998 Revenue and Veterans G.O. Bonds have been treated for federal income tax purposes as refunding certain bonds issued to finance the Program, the requirements described below are not applicable to all of the Contracts of Purchase allocable to or financed by the 1997/1998 Revenue and Veterans G.O. Bonds. However, Contracts of Purchase (or portions of new Contracts of Purchase) entered into with respect to properties acquired with amounts allocable to the 1997 Series C Bonds (the "1997C Contracts") are subject to such requirements *except* as noted below. (The 1997C Contracts and the Contracts of Purchase financed by or allocated to the 1997/1998 Revenue and Veterans G.O. Bonds to which the requirements apply are referred to as the "1997/1998 Contracts.")

### *Loan Eligibility Requirements Imposed by the Federal Tax Code*

The Federal Tax Code contains the following loan eligibility requirements, all of which are applicable to 1997/1998 Contracts (except that the requirements described under "First-Time Homebuyer Requirement," "Purchase Price Limitation," and "Other Requirements Imposed by the Code—Recapture Provision" do not apply to home improvement loans, and the requirements described under "Qualified Home Improvement Loans" do not apply to loans for the acquisition of single family homes). These requirements must be satisfied for 1997/1998 Contracts in order that interest on the 1997 Series C Bonds not be included in gross income for federal income tax purposes retroactive to their date of issuance.

Generally, only the requirements described below under the headings "Residence Requirement," "New Mortgage Requirement" and "Qualified Home Improvement Loans" (except the \$15,000 maximum loan amount) apply to any Contracts of Purchase financed with Veterans G.O. Bonds.

**Residence Requirement.** The Federal Tax Code requires that each of the premises financed with proceeds of qualified mortgage bonds be a one-to-four-family residence, one unit of which can reasonably be expected to become the principal residence of the veteran within a reasonable time

after the financing is provided. Certain documents adopted by the Department establish procedures to be followed in connection with 1997/1998 Contracts which finance the acquisition of single family homes in order to assure that interest paid on the 1997 Series C Bonds not be included in gross income for federal income tax purposes under the Federal Tax Code (the "Single Family Program Documents"). Certain documents adopted by the Department establish procedures to be followed in connection with 1997/1998 Contracts to finance home improvement loans in order to assure that interest paid on the 1997 Series C Bonds is not included in gross income for federal income tax purposes under the Federal Tax Code (the "Home Improvement Program Documents"; together with the Single Family Program Documents, the "Program Documents"). In connection with the financing of a 1997/1998 Contract, the Program Documents require that each veteran submit an affidavit stating such person's intention to occupy the premises as his principal residence within 60 days after closing of the 1997/1998 Contract.

***First-Time Homebuyer Requirement.*** The Federal Tax Code requires that, subject to certain exceptions, the lendable proceeds of qualified mortgage bonds be used to provide financing to borrowers who have not had a present ownership interest in their principal residence during the three-year period prior to execution of the mortgage loan. This limitation, however, does not apply to the mortgagor's interest in the residence being financed or to certain residences in certain Presidentially-declared disaster areas; and all financing with respect to targeted area residences and residences on land possessed under certain contract for deed agreements is treated as satisfying the first time homebuyer requirement. Veterans subject to this requirement are required to provide federal income tax returns for the previous three years or other appropriate certifications to allow verification that no deductions or other entries have been made that would indicate any such ownership interest.

***New Mortgage Requirement.*** The Federal Tax Code requires that, with certain limited exceptions, the lendable proceeds of qualified mortgage bonds finance new mortgage loans only and that no proceeds may be used to acquire or replace an existing mortgage loan, which would include the refinancing of a pre-existing mortgage loan. The Department verifies compliance with the new mortgage requirement by requiring each veteran to certify prior to financing, subject to such exceptions, that no refinancing of a prior mortgage loan is being effected.

***Purchase Price Limitation.*** The Federal Tax Code requires that the purchase price of the residence financed with the lendable proceeds of qualified mortgage bonds may not exceed 90% of the average area purchase price applicable to such residence or 110% of the applicable average area purchase price in the case of residences located in targeted areas or residences in certain Presidentially-declared disaster areas. The Department verifies compliance with the purchase price limitations by requiring each veteran and seller of a residence to make certifications regarding the purchase price of such residence.

***Income Limitation.*** The Federal Tax Code requires that all mortgage loans made from the lendable proceeds of qualified mortgage bonds be made only to borrowers whose family income does not exceed 115% (for mortgage loans made to families with fewer than three members, 100%) of the applicable median family income. An exception is provided for mortgage loans financed with the lendable proceeds of qualified mortgage bonds made with respect to targeted area residences and residences in certain Presidentially-declared disaster areas that permits two-thirds in aggregate amount of such mortgage loans to be made with respect to borrowers whose family income does not exceed 140% (for mortgage loans made to families with fewer than three members, 120%) of the applicable median family income and one-third in aggregate amount of such loans to be made without regard to any income limitation. All mortgage loans financed with the lendable proceeds of qualified mortgage bonds made with respect to may be made to borrowers whose family income does not exceed such 140% (or 120%) limitations.

Federal tax law permits higher income limits for persons financing homes located in certain "high housing cost areas." A high housing cost area is a statistical area for which the ratios of the area's average purchase price for existing and new single family houses to the area's median income exceed 120% of the same ratios determined on a national basis. These ratios are determined separately with respect to new and existing single family residences. An area is a high housing cost area only if the ratios for both new and existing houses meet the 120% test. In high housing cost areas, the veteran income limits are increased above 115% (or 100%, as applicable) by one percent for each percentage point (1%) by which the new or existing housing price ratio, whichever is smaller, exceeds 120%. However, the new limit cannot exceed 140% (or 120%, as applicable) of the income limits otherwise applicable. Certain areas of the State may qualify as high housing cost areas.

Family income includes income of all individuals executing both the note and mortgage and occupying the dwelling as their principal residence.

**Requirements as to Assumptions.** The Federal Tax Code provides that a mortgage loan may be assumed only if each of the then applicable residence requirement, first-time-homebuyer requirement, purchase price limitation, and income limitation is met with respect to such assumption. The 1997/1998 Contracts will contain a "due on sale" clause, and the Department will not permit the assumption of a 1997C Contract unless it has determined that these requirements have been met and has obtained the appropriate certifications.

**Qualified Home Improvement Loans.** The Federal Tax Code requires that a home improvement loan financed with the lendable proceeds of qualified mortgage bonds not exceed \$15,000, be made only with respect to an owner-occupied residence, and finance alterations, repairs, and improvements on or in connection with an existing one-to-four-family residence by the owner thereof, but only if such alterations, repairs and improvements substantially protect or improve the basic livability or energy efficiency of the property.

**General.** An issue of qualified mortgage bonds is treated as meeting the loan eligibility requirements of the Federal Tax Code if (i) the issuer in good faith attempted to meet all the loan eligibility requirements before the mortgage loans were executed, (ii) any failure to comply with the loan eligibility requirements is corrected within a reasonable period after such failure is first discovered, and (iii) 95% or more of the proceeds of the issue used to make mortgage loans was used to finance residences that met all such requirements at the time the mortgage loans were executed. In determining whether 95% or more of the proceeds has been so used, the Federal Tax Code permits the Department to rely on an affidavit of the veteran and of the seller as to the purchase price of a residence and an affidavit of the veteran and an examination of copies of the veteran's federal income tax returns for the last three years preceding the date the Contract of Purchase is or was executed even though the relevant information in such affidavits and income tax returns should ultimately prove to be untrue, unless the Department knows or has reason to believe that such information is false.

#### ***Other Requirements Imposed by the Federal Tax Code***

**General.** Failure to comply with the applicable provisions of the Federal Tax Code may result in interest on the applicable issue of bonds being included in gross income for federal income tax purposes retroactive to the date of issuance thereof. The Federal Tax Code provides that gross income for federal income tax purposes does not include interest on a mortgage revenue bond if it is a qualified mortgage bond or a qualified veterans' mortgage bond. A qualified mortgage bond is a part of an issue of a state or political subdivision all the proceeds of which (net of amounts applied to any costs of issuance thereof and to fund a reasonably required reserve) are used to finance or to refund bonds all of such proceeds of which were used to finance owner-occupied

residences and that meets certain (i) general requirements, (ii) arbitrage restrictions on the use and investment of proceeds of the issue, and (iii) loan eligibility requirements set forth in the Federal Tax Code and as more fully described above under "Loan Eligibility Requirements Imposed by the Federal Tax Code." A qualified veterans' mortgage bond is part of an issue 95 percent or more of the net proceeds of which are used to provide residences to veterans and that meets certain (i) general requirements, (ii) arbitrage restrictions on the use and investment of proceeds of the issue, and (iii) loan eligibility requirements set forth in the Federal Tax Code and as more fully described above under "Loan Eligibility Requirements Imposed by the Federal Tax Code."

The first general requirement of the Federal Tax Code, which is applicable to the Offered 1999 Revenue Bonds, is that the aggregate amount of private activity bonds (exclusive of qualified veterans' mortgage bonds) that may be issued by the Department in any calendar year (or previous years' carried forward amount) must not exceed the portion of the private activity bond volume limit for the State for such calendar year that is allocated by the State to the Department. With respect to qualified veterans' mortgage bonds, the limit is based on statutory formula. The Offered 1999 Revenue Bonds are within the applicable limit for the Department. The 1997 Series C Bonds met such requirement at the time they were issued. The second general requirement of the Federal Tax Code, which is applicable to the 1997 Series C Bonds but not to the Offered 1999 Revenue Bonds, is that at least 20% of the lendable proceeds of an issue of bonds which are not refunding bonds (if such set-aside was satisfied with respect to the bonds being refunded) must be made available (and applied with reasonable diligence) for owner-financing of residences in targeted areas (as defined by the Federal Tax Code) for at least one year after the date on which such funds are first available for such owner-financing (the "targeted area requirement"). The Department has covenanted to comply with such requirements to the extent required by the Federal Tax Code.

The Federal Tax Code requires the issuer of qualified mortgage bonds and qualified veterans' mortgage bonds to file with the Internal Revenue Service reports on the issuance of its qualified mortgage bonds following such issuance, as well as an annual qualified mortgage loan information report. The Department has covenanted to file, as required, such reports with respect to the 1997 Series C Bonds.

The Federal Tax Code requires that the effective interest rate on mortgage loans financed with the lendable proceeds of qualified mortgage bonds and qualified veterans' mortgage bonds may not exceed the yield on the issue by more than 1.125% (1.50% for the Offered 1999 Revenue Bonds), and that certain investment earnings on non-mortgage investments, calculated based upon the extent such investment earnings exceed the amount that would have been earned on such investments if the investments were invested at a yield equal to the yield on the issue, be rebated to the United States or to veterans. These requirements apply to both Revenue Bonds and Veterans G.O. Bonds, except that for Veterans G.O. Bonds, rebate, absent an election to pay to the United States, is to veterans. The Department has covenanted to comply with these requirements and has established procedures to determine the amount of excess earnings, if any, that must be rebated to the United States or to veterans. See "SECURITY FOR AND SOURCES OF PAYMENT OF THE REVENUE BONDS—The 1943 Fund" and "THE PROGRAM—Contracts of Purchase" for discussions of provisions of the Veterans Code which affect the Department's ability to establish and to change interest rates on Contracts of Purchase.

**Recapture Provision.** For certain mortgage loans made after December 31, 1990 from the proceeds of qualified mortgage bonds issued after August 15, 1986, and for assumptions of such mortgage loans, the Federal Tax Code requires a payment to the United States from certain borrowers upon sale or other disposition of their homes (the "Recapture Provision"). The Recapture Provision requires that an amount determined to be the subsidy provided by a qualified mortgage bond financing to a borrower be paid to the United States on disposition of the house (but not in excess of 50% of the gain realized by the borrower). The recapture amount would (i)

increase over the period of ownership, with full recapture occurring if the house were sold between four and five full years after the closing of the mortgage loan and (ii) decline ratably to zero with respect to sales occurring between five and nine full years after the closing of the mortgage loan. An exception excludes from recapture part or all of the subsidy in the case of certain assisted individuals whose incomes are less than prescribed amounts at the time of the disposition. The Federal Tax Code requires an issuer to inform borrowers of certain information with respect to the Recapture Provision. The Department has established procedures which the Department believes has enabled it to meet, and will enable it to continue to meet, such recapture information requirement.

**Veterans' Provisions.** The Federal Tax Code requires that each mortgagor to whom financing is provided under a qualified veterans' mortgage bond issue have served on active duty at some time before January 1, 1977 and apply or applied for financing before the later of January 31, 1985 or the date which is 30 years after the last date on which the veteran left active service. The Department has established procedures and has covenanted to comply with such requirement.

The Federal Tax Code states that an issuer will be treated as meeting the targeted area requirement, the arbitrage restrictions on mortgage loans, and the recapture information requirements if it in good faith attempted to meet all such requirements and any failure to meet such requirements was due to inadvertent error after taking all reasonable steps to comply with such requirements.

**Required Redemptions.** For qualified mortgage bonds issued after 1988, the Federal Tax Code permits repayments (including prepayments) of principal of mortgage loans financed with the proceeds of an issue of such bonds to be used to make additional mortgage loans for only 10 years from the date of issuance of the bonds (or the date of issuance of the original bonds in the case of refundings), after which date such amounts must be used to redeem bonds, except for a \$250,000 de minimis amount. As a result, the Department is required by the Federal Tax Code to redeem the 1997/1998 Revenue and Veterans G.O. Bonds (including the 1997 Series C Bonds but not the Offered 1999 Revenue Bonds) from repayments (including prepayments) of principal of certain 1997/1998 Contracts not later than the close of the semi-annual period after the payment is received.

**Compliance.** The Department included provisions in the Program Documents that establish procedures, including receipt of certain affidavits from veterans, in order to assure compliance with the loan eligibility requirements and other requirements that must be satisfied subsequent to the date of issuance of the applicable Offered Revenue Bonds. The Department has covenanted in the Resolution to do and perform all acts and things permitted by law and necessary or desirable to assure that interest paid on the Offered 1999 Revenue Bonds and 1997 Series C Bonds shall not be included in gross income for federal income tax purposes and, for such purpose, to adopt and maintain appropriate procedures.

#### ***Opinions of the Attorney General and Bond Counsel***

**Offered 1999 Revenue Bonds.** In the opinions of the Attorney General and of Hawkins, Delafield & Wood, Bond Counsel (expected to be delivered in substantially the forms set forth in Exhibit F), under existing statutes and court decisions, (i) interest on the Offered 1999 Revenue Bonds is not included in gross income for federal income tax purposes pursuant to Section 103 of the Federal Tax Code, and (ii) interest on the Offered 1999 Revenue Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Federal Tax Code with respect to individuals and corporations; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations. In rendering such opinion, the Attorney General and

Bond Counsel assume compliance by the Department with and enforcement by the Department of the Resolution and the applicable Program Documents. The Attorney General and Bond Counsel express no opinion as to the exclusion from gross income of interest on any Offered 1999 Revenue Bond subsequent to any date on which action is taken pursuant to the Resolution for which action the Resolution requires a legal opinion to the effect that taking such action will not adversely affect such exclusion, unless the Attorney General and such firm delivers an opinion as of such date to such effect.

**1997 Series C Bonds.** The then-Attorney General and Hawkins, Delafield & Wood, Bond Counsel, delivered opinions in connection with the issuance of the 1997 Series C Bonds (the form of which is set forth in Exhibit G), dated such date of issuance. Each such opinion stated that based on then-existing statutes and court decisions, (i) interest on the 1997 Series C Bonds was not included in gross income for federal income tax purposes pursuant to Section 103 of the Federal Tax Code, and (ii) interest on the 1997 Series C Bonds would be treated as a preference item for purposes of calculating the federal alternative minimum tax imposed under the Federal Tax Code with respect to individual and corporations. In rendering such opinions, the then-Attorney General and Bond Counsel assumed compliance by the Department with and enforcement by the Department of the Resolution and the applicable Program Documents. In rendering such opinions, the then-Attorney General and Bond Counsel also relied on the approving opinion of Orrick Her- rington & Sutcliffe LLP with respect to Veterans G.O Bonds which are 1997/1998 Revenue and Veterans G.O. Bonds and on the authorizing documents with respect to the 1997/1998 Revenue and Veterans G.O. Bonds as to the validity and legality of such bonds and as to the exclusion of the interest thereon from gross income of the owners thereof for federal income tax purposes. The Attorney General and Bond Counsel expressed no opinion as to the exclusion from gross income of interest on any 1997 Series C Bond subsequent to any date on which action is taken pursuant to the Resolution for which action the Resolution requires a legal opinion to the effect that taking such action will not adversely affect such exclusion unless the Attorney General and such firm delivers an opinion as of such date to such effect. It is a condition to the remarketing of the 1997 Series C Bonds that the Attorney General and Bond Counsel deliver opinions on the remarketing date that not converting the interest rate on the 1997 Series C Bonds on such date to fixed rates of interest will not, in and of itself, adversely affect the exclusion of interest on the 1997 Series C Bonds from gross income for federal income tax purposes.

#### ***Certain Additional Federal Tax Consequences***

The following is a brief discussion of certain federal income tax matters with respect to the Offered Revenue Bonds under existing statutes. It does not purport to deal with all aspects of federal taxation that may be relevant to a particular owner of an Offered Revenue Bond. Prospective investors, particularly those who may be subject to special rules, are advised to consult their own tax advisors regarding the federal tax consequences of owning and disposing of the Offered Revenue Bonds.

As noted above, interest on the 1997 Series C Bonds is a preference item in determining the tax liability of individuals, corporations, and other taxpayers subject to the alternative minimum tax imposed by Section 55 of the Code. Interest on the Offered Revenue Bonds must also be taken into account in determining the tax liability of foreign corporations subject to the branch profits tax imposed by Section 884 of the Federal Tax Code.

Owners of Offered Revenue Bonds should be aware that the ownership of such obligations may result in collateral federal income tax consequences to various categories of persons, such as corporations (including S corporations and certain foreign corporations), financial institutions, property and casualty insurance companies, individual recipients of Social Security or Railroad



Retirement benefits, and individuals otherwise eligible for the earned income tax credit and to taxpayers deemed to have incurred or continued indebtedness to purchase or carry obligations the interest on which is not included in gross income for federal income tax purposes.

Legislation affecting municipal bonds is frequently considered by the United States Congress. There can be no assurance that legislation enacted or proposed after the date of issuance of the Offered 1999 Revenue Bonds or date of remarketing of the 1997 Series C Bonds will not have an adverse effect on the tax-exempt status or market price of the applicable Offered Revenue Bonds.

### **State Tax Matters**

The Attorney General and Bond Counsel are of the opinion that the interest on the Offered 1999 Revenue Bonds is exempt from personal income taxes of the State of California under present State law.

In the opinion of the then-Attorney General and Hawkins, Delafield & Wood, Bond Counsel, delivered on the date of issuance of the 1997 Series C Bonds, under then-existing statutes, interest on the 1997 Series C Bonds was exempt from personal income taxes of the State of California.

## **LITIGATION**

### **No Material Litigation**

At the time of the delivery of and payment for the Offered Revenue Bonds, the Department shall deliver, or cause to be delivered (1) a certificate of the Attorney General of the State to the effect that, to the best of his knowledge, no material litigation is pending or threatened in any court to restrain or enjoin the issuance, remarketing or delivery of any of the Offered Revenue Bonds or the collection of Revenues or in any way contesting or affecting any authorization for, or the validity of, the Offered Revenue Bonds or the Resolution; and that, with respect to the officers who executed the Offered Revenue Bonds on behalf of the Department, to the best of his knowledge, the title of said officers to their respective offices is not being contested or questioned, and (2) an opinion of Chief Counsel to the Department to the effect that, to the best of his knowledge, other than as described in the following paragraphs, no litigation is pending or threatened against the Department involving any of the property or assets of the 1943 Fund, the Bond Reserve Account or the Loan Loss Account that involves the possibility of any judgment or uninsured liability which may result in any material adverse change in the business, properties, assets or in the condition, financial or otherwise, of the 1943 Fund, the Bond Reserve Account or the Loan Loss Account; and that, with respect to the officers who executed the Offered Revenue Bonds on behalf of the Department, to the best of his knowledge, the title of said officers to their respective offices is not being contested or questioned.

### **Debbs Litigation**

On June 25, 1996, the Department was served with a summons and complaint initiating a lawsuit entitled *John L. Debbs, et al. v. California Department of Veterans Affairs, et al.* (Superior Court of California, County of Los Angeles, Case No. BC 151476). The third amended complaint alleges "fraudulent concealment, declaratory relief, injunctive relief, and damages for monies unlawfully taken from the California Veterans Farm and Home Life and Disability Protection Plan." Plaintiff claims that in 1983, when the Department canceled its contracts with two life insurance companies then responsible for underwriting the life and disability programs, over \$100 million was illegally expended by the Department, and that certain transfers from the life and disability reserves to the 1943 Fund were unlawful. The complaint seeks, among other things, that

premiums under the life and disability program be reduced to prior levels and the return of the moneys, plus interest, from the 1943 Fund to the life and disability reserves. Plaintiffs' attempts to obtain a preliminary injunction and temporary restraining order from the court have been unsuccessful. Plaintiffs are seeking to convert this action into a class action suit. The court commissioner ordered Plaintiffs' attorney to pay the costs of notifying the class. A hearing on conversion to a class action suit is scheduled in May 1999.

In 1997, John L. Debbs and his wife filed a separate federal court action (entitled *John L. Debbs and Patsy R. Debbs v. Jay Vargas, et al.*) (United States District Court, Eastern District of California, Case No. Civ-S-97-0123). Although the court dismissed most of the defendants, the case is still pending against Pacific Mutual Life Insurance Company and three former Board members. The claims allege violation of constitutional rights, fraud, misappropriation, conspiracy, violation of equal protection, slander, bad faith, breach of fiduciary duty, "arbitrage violations" and other purported misdeeds. The complaint covers a period of approximately twenty years and requested a restraining order, injunctive relief, a receivership of the 1943 Fund and of the Program, criminal relief and general, compensatory, punitive, prospective, consequential, and special damages of over \$3,550,000.

In 1998, Mr. and Mrs. Debbs filed an additional federal court action, essentially repeating the charges and damages (albeit for a larger amount) contained in the 1997 action.

On June 1, 1998, the federal district court judge dismissed both of the above-mentioned cases because of lack of a federal question. Plaintiffs have appealed the dismissal of the 1997 case to the Ninth Circuit Court of Appeals. The matter has been briefed, and a response from the Ninth Circuit Court is expected. No appeal was filed in the 1998 case.

The Department is vigorously opposing these lawsuits. While the outcome of any litigation cannot be predicted with certainty, the Department expects ultimately to prevail in these matters. Even if the respective Plaintiffs should prevail in all of these matters, the Department does not expect such outcome to affect its ability to make timely payment of debt service on the Revenue Bonds.

#### **Jarvis Litigation**

In June 1998, a complaint was filed in Los Angeles County Superior Court in the case of *Howard Jarvis Taxpayers Association v. Connell* challenging the authority of the State Controller to make payments in the absence of a State budget. The lawsuit did not specifically attack the Department, the 1943 Fund, or the continuing appropriations in the Veterans Code of funds to pay principal and interest on Revenue Bonds. The Superior Court judge, however, issued a preliminary injunction preventing the State Controller from making payments, including those made pursuant to continuing appropriations, while the State's annual budget act had not yet been enacted. As permitted by the State Constitution, the Legislature immediately enacted and the Governor signed, an emergency appropriations bill which allowed continued payment of various State obligations, including debt service.

On July 22 and 27, 1998, various employee unions which had intervened in the case appealed the trial court's preliminary injunction and asked the Court of Appeal to stay the preliminary injunction. On July 28, 1998, the Court of Appeal granted the unions' requests and stayed the preliminary injunction pending the Court of Appeal's decision on the merits of the appeal. On August 5, 1998, the Court of Appeal denied the plaintiff's request to reconsider the stay. Also on July 22, 1998, the State Controller asked the California Supreme Court to immediately stay the trial court's preliminary injunction and to overrule the order granting the preliminary injunction on the merits. On July 29, 1998, the Supreme Court transferred the State Controller's request to the Court of Appeal. The matters are now pending before the Court of Appeal. Briefs have been submitted; no date has yet been set for oral argument.

The Attorney General and Hawkins, Delafield & Wood, Bond Counsel, have rendered opinions, subject to the conditions and limitations set forth therein, that the conclusion of the Superior Court judge in the *Jarvis* case (which is now stayed pending appeal) questioning the validity of continuing appropriations, if and to the extent it would apply to Revenue Bonds, is without merit and that the California appellate courts would hold that the appropriations for debt service on Revenue Bonds contained in the Veterans Code are valid under the California Constitution and that the Controller may make payments pursuant to such appropriations. While there can be no assurance as to the outcome of litigation, the Department believes moneys will be available in due course on a timely basis to make all future payments of debt service.

### **UNDERWRITING**

The Offered Revenue Bonds are being purchased by the Underwriters listed on the front cover page. The Underwriters have jointly and severally agreed to purchase the 1997 Series C Bonds and 1999 Series A Bonds on or about March 30, 1999 for a purchase price of \$153,999,450 plus accrued interest, and in connection therewith the Department will pay a fee to the Underwriters of \$847,485.45. The Underwriters have jointly and severally agreed to purchase the 1999 Series B Bonds on or about May 4, 1999 for a purchase price of \$85,810,331.25 plus accrued interest, and in connection therewith the Department will pay a fee to the Underwriters of \$682,607.91. The initial public offering prices of the Offered 1999 Revenue Bonds may be changed from time to time by the Underwriters.

Each purchase contract relating to the Offered Revenue Bonds provides that the Underwriters will purchase all of the applicable Offered Revenue Bonds if any are purchased, and that the obligation to make such purchase is subject to certain terms and conditions set forth in such purchase contract including, among others, the approval of certain legal matters by counsel.

### **CERTAIN LEGAL MATTERS**

Legal matters incident to the authorization, issuance, sale and delivery of the Offered 1999 Revenue Bonds to the Underwriters are subject to the approval of The Honorable Bill Lockyer, Attorney General of the State of California, and of Hawkins, Delafield & Wood, Bond Counsel. The respective issuances and acceptances of the Offered 1999 Revenue Bonds are conditioned upon delivery by Bond Counsel of the applicable approving opinion in substantially the applicable form set forth in Exhibit F hereto. Certain legal matters will be passed upon for the Underwriters by their counsel, Kutak Rock.

Events occurring between the date of this Official Statement and the date of issuance of the 1999 Series B Bonds, including changes in State law or federal tax law, may affect the ability of Bond Counsel to deliver the approving legal opinion with respect to the 1999 Series B Bonds in the applicable form set forth in Exhibit F. Delivery of an approving legal opinion in substantially such form is a condition to the issuance of the 1999 Series B Bonds.

### **FINANCIAL STATEMENTS**

The financial statements of the 1943 Fund and the Veterans Debenture Revenue Fund as of June 30, 1998 and June 30, 1997 and for the years then ended, have been audited by Deloitte & Touche LLP, independent auditors, as indicated in their reports appearing therein. See Exhibits A and B.

## **LEGALITY FOR INVESTMENT**

The Act provides that the Offered Revenue Bonds shall be legal investments in California for all trust funds, funds of all insurance companies, banks (both commercial and savings), trust companies, state school funds, and pension funds, public or private. The Act also provides that any money or funds which may by law be invested in bonds of the State may be invested in the Offered Revenue Bonds and that whenever any bonds of the State may by law be used as security for the performance of any act or the deposit of any public money, the Offered Revenue Bonds may be so used.

## **RATINGS**

Fitch, Moody's, and S&P have given the 1999 Series A Bonds and 1999 Series B Bonds the ratings of AA-, Aa3, and AA- respectively. Fitch, Moody's and S&P have confirmed the 1997 Series C Bonds the ratings of AA-/F1+, Aa3/VMIG1, and AA-/A-1+, respectively, until the Mandatory Tender Date on which the interest rate on such 1997 Series C Bonds is converted to a fixed interest rate to their maturity. Such ratings reflect only the view of such organizations and an explanation of the significance such ratings may be obtained from them. There is no assurance that such ratings will continue for any given period of time or that they will not be revised downward or withdrawn entirely, if in the judgment of the respective rating agencies circumstances so warrant. Any such downward revision or withdrawal of any of such ratings may have an adverse effect on the market price of the applicable Offered Revenue Bonds.


## **CONTINUING DISCLOSURE**

The Department has covenanted in a Master Continuing Disclosure Undertaking (the "Master Continuing Disclosure Undertaking"), for the benefit of the Bondowners and Beneficial Owners (each as defined in Exhibit C) of the Offered Revenue Bonds, to provide certain financial information and operating data relating to the Department (the "Annual Financial Information") by not later than the first day of the tenth calendar month following the end of the Department's then-current fiscal reporting period, commencing with the reporting period ending June 30, 1997, and to provide notices of the occurrence of certain enumerated events, if material. The Master Continuing Disclosure Undertaking requires that the Annual Financial Information be filed by the Department with the Trustee, with the State information depository (the "SID"), if any, and with each nationally recognized municipal securities information repository (each, an "NRMSIR"). The Master Continuing Disclosure Undertaking requires that notices of material events be filed by the Department with the Trustee, with the SID and with either of each NRMSIR or the Municipal Securities Rulemaking Board. The specific nature of the information to be contained in the Annual Financial Information or the notices of material events is summarized in Exhibit D—"SUMMARY OF CERTAIN PROVISIONS OF THE MASTER CONTINUING DISCLOSURE UNDERTAKING." These covenants have been made in order to assist the Underwriters in complying with Rule 15c2-12(b)(5) promulgated by the Securities and Exchange Commission (the "Rule"). The Department has never failed to comply in all material respects with any previous undertakings with respect to the Rule to provide annual financial information or notices of material events.

## MISCELLANEOUS

The information set forth herein is subject to change without notice and no implication should be derived therefrom or from the sale of the Offered Revenue Bonds that there has been no change in the affairs of the Department after the date hereof. The distribution of this Official Statement has been duly authorized by the Department. Any statement in this Official Statement involving matters of opinion, whether or not expressly so stated, is intended as such, and not as a representation of fact. Concurrently with the delivery of the Offered Revenue Bonds, the Department will furnish a certificate to the effect that this Official Statement, as of its date and as of the date of delivery of the Offered Revenue Bonds, does not and will not contain any untrue statement of a material fact or omit to state any material fact necessary to make the statements herein, in the light of the circumstances under which they were made, not misleading. The agreement of the Department with the holders of the Offered Revenue Bonds is set forth in the Resolution. This Official Statement is not to be construed as an agreement or contract between the Department and the purchaser or holder of any of the Offered Revenue Bonds. Additional information may be obtained from the Department at 1227 "O" Street, Sacramento, California 95814, Attention: Bond Finance Division.

### DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA



By /s/ Curtis Howard  
Deputy Secretary, Administration

Dated: March 17, 1999

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**EXHIBIT A**

**FINANCIAL STATEMENTS OF THE 1943 FUND  
FOR FISCAL YEARS 1998 AND 1997  
AND INDEPENDENT AUDITOR'S REPORT**

**VETERANS FARM AND HOME BUILDING FUND OF 1943  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

Financial Statements for the Years Ended June 30, 1998 and 1997 and  
Independent Auditors' Report

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# Deloitte & Touche



Deloitte & Touche LLP

Suite 2000

400 Capital Mall

Sacramento, California 95814-4424

Telephone: (916) 498-7100

Facsimile: (916) 444-7963

## INDEPENDENT AUDITORS' REPORT

California Veterans Board  
State of California  
Sacramento, California

We have audited the accompanying balance sheets of the Veterans Farm and Home Building Fund of 1943, Department of Veterans Affairs of the State of California (Fund) as of June 30, 1998 and 1997, and the related statements of revenues, expenses and changes in retained earnings, and of cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements referred to above present only the Veterans Farm and Home Building Fund of 1943, and are not intended to present the financial position of the Department of Veterans Affairs of the State of California and the results of its operations and cash flows of its proprietary fund types.

In our opinion, such financial statements referred to above present fairly, in all material respects, the financial position of the Veterans Farm and Home Building Fund of 1943, Department of Veterans Affairs of the State of California as of June 30, 1998 and 1997, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note 1 to the financial statements, in 1998 the Department of Veteran Affairs of the State of California, changed its method of accounting for investments of the Fund to conform with Governmental Accounting Standards Board Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, and, retroactively, restated its 1997 financial statements for the change.

*Deloitte + Touche LLP*

October 9, 1998

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**BALANCE SHEETS**

**JUNE 30, 1998 AND 1997 (in thousands)**

<b>ASSETS</b>	<b>1998</b>	<b>1997 (as restated, see Note 1)</b>
Cash in State Treasury	\$ 6,553	\$ 12,773
Investments:		
Unrestricted	571,598	688,770
Restricted	873,909	327,190
Insurance administrators	<u>42,673</u>	<u>50,613</u>
	1,488,180	1,066,573
Total cash and investments	1,494,733	1,079,346
Receivables under contracts of sale, net of allowance for uncollectible contracts of \$22,005 and \$26,412 in 1998 and 1997, respectively	2,013,874	2,127,730
Due from Veterans Debenture Revenue Fund	12,686	87,479
Interest receivable:		
State of California's Surplus Money Investment Fund	3,101	477
Investments	9,608	17,766
Due from other funds	1,046	4,353
Other real estate owned, net of allowance for losses of \$19,003 and \$24,003 in 1998 and 1997, respectively	43,869	51,035
Land, improvements and equipment, net of accumulated depreciation of \$5,972 and \$5,244 in 1998 and 1997, respectively	8,620	7,834
Other	<u>92</u>	<u>976</u>
<b>TOTAL ASSETS</b>	<b><u>\$3,587,629</u></b>	<b><u>\$3,376,996</u></b>
<b>LIABILITIES AND RETAINED EARNINGS</b>		
LIABILITIES:		
Accrued interest and other liabilities	\$ 58,458	\$ 80,502
Bonds payable - net	3,194,526	2,953,312
Insurance claims payable and loss reserves	<u>56,244</u>	<u>69,083</u>
Total liabilities	3,309,228	3,102,897
RETAINED EARNINGS	<u>278,401</u>	<u>274,099</u>
<b>TOTAL LIABILITIES AND RETAINED EARNINGS</b>	<b><u>\$3,587,629</u></b>	<b><u>\$3,376,996</u></b>

See notes to financial statements.

**VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN RETAINED EARNINGS  
YEARS ENDED JUNE 30, 1998 AND 1997 (in thousands)**

	1998	1997 (as restated, see Note 1)
<b>PROGRAM OPERATIONS:</b>		
Interest revenues:		
Contracts of sale of properties	\$ 162,086	\$ 175,186
Investments and other	78,621	79,525
Transfers of interest revenue from Veterans Debenture Revenue Fund	<u>8,441</u>	<u>10,843</u>
Total program operations revenues	249,148	265,554
Expenses:		
Interest expense	218,757	230,871
Provision for contract losses	<u>1,312</u>	<u>22,677</u>
Total program operations expenses	<u>220,069</u>	<u>253,548</u>
Excess of program operations revenues and transfers over interest expense and provision for contract losses	<u>29,079</u>	<u>12,006</u>
<b>PROGRAM ADMINISTRATION:</b>		
Revenues:		
Loan servicing fees	1,594	1,385
Other income	297	905
Excess of amounts charged to contract holders over fire and hazard insurance claims and expenses and changes in insurance reserves	<u>2,086</u>	<u>326</u>
Total program administration revenues	3,977	2,616
Expenses:		
Payroll and related costs	11,404	11,342
General expenses	13,596	8,876
Excess of self-insured life and disability insurance claims and expenses and changes in insurance reserves over amounts charged to contract holders	<u>626</u>	<u>162</u>
Total program administration expenses	<u>25,626</u>	<u>20,380</u>
Excess of program administration expenses over program administration revenues	<u>(21,649)</u>	<u>(17,764)</u>
<b>LOSS ON SALE OF REPOSSESSED PROPERTY</b>	<u>(3,128)</u>	<u>(8,309)</u>
<b>EXCESS (DEFICIENCY) OF REVENUES AND TRANSFERS     OVER EXPENSES</b>	4,302	(14,067)
<b>RETAINED EARNINGS:</b>		
Beginning of year - as restated	<u>274,099</u>	<u>288,166</u>
End of year	<u>\$ 278,401</u>	<u>\$ 274,099</u>

See notes to financial statements.

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**STATEMENTS OF CASH FLOWS  
YEARS ENDED JUNE 30, 1998 AND 1997 (in thousands)**

	1998	1997 (as restated, see Note 1)
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Excess (deficiency) of revenues and transfers in over expenses	\$ 4,302	\$ (14,067)
Adjustments to reconcile to net cash used by operating activities:		
Amortization of bond premiums, discounts and issuance costs	2,494	(46)
Depreciation expense	727	716
Loss on sale of repossessed property	3,128	8,309
Effect of changes in assets and liabilities:		
Interest receivable - State of California's Surplus Money Investment Fund	(2,624)	2,509
Interest receivable - investments	8,158	4,229
Due from other funds	3,307	(5,162)
Other real estate owned	4,038	(2,189)
Other assets	884	144
Accrued interest and other liabilities	(22,044)	(6,214)
Insurance claims payable and loss reserves	<u>(12,839)</u>	<u>(13,757)</u>
Net cash used by operating activities	<u>(10,469)</u>	<u>(25,528)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Net decrease in receivables under contracts of sale	113,856	90,778
Net (increase) decrease in investment securities	(421,607)	110,001
Purchase of land, improvements and equipment	<u>(1,513)</u>	<u>(113)</u>
Net cash provided (used) by investing activities	<u>(309,264)</u>	<u>200,666</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from sales of bonds	1,613,366	
Maturities of bonds payable	(1,325,996)	(198,160)
Early redemption of bonds payable	(48,650)	(30,000)
Net change in Due from Veterans Debenture Revenue Fund	<u>74,793</u>	<u>51,681</u>
Net cash provided (used) by financing activities	<u>313,513</u>	<u>(176,479)</u>
<b>DECREASE IN CASH IN STATE TREASURY</b>	<b>(6,220)</b>	<b>(1,341)</b>
<b>CASH IN STATE TREASURY:</b>		
Beginning of year	<u>12,773</u>	<u>14,114</u>
End of year	<u>\$ 6,553</u>	<u>\$ 12,773</u>

See notes to financial statements.

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**NOTES TO FINANCIAL STATEMENTS  
YEARS ENDED JUNE 30, 1998 AND 1997**

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**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Organization and Description - The California Department of Veterans Affairs (the Department) is a separate legal entity and a Cabinet level agency of the State of California. A seven-member California Veterans Board (the Board) has policy oversight of the operations of the Department. The Board's membership consists of the Department Secretary and six members, all of whom are appointed by the Governor, subject to confirmation by the State Senate. The Veterans Farm and Home Building Fund of 1943 (the Fund) was established under the authority of the California Constitution to provide low-interest, long-term farm and home mortgage loan contracts to veterans living in California. The contract loan program has been continuous since 1922. Proceeds from the sale of general obligation bonds, periodically authorized by the vote of the people of California, and revenue bonds authorized by the Legislature are used for contract loans to veterans. Expenditures are primarily for debt service and administration of the program. The Fund is tax exempt.

The financial statements represent only the activities of the Veterans Farm and Home Building Fund of 1943, and are not intended to present the financial position of the Department of Veterans Affairs of the State of California and the results of its operations and cash flows of its proprietary fund types. The financial statements of the Fund are included in the financial statements of the State of California as the State represents the primary government and has ultimate oversight responsibility for the Fund.

New Accounting Pronouncements - The Governmental Accounting Standards Board (GASB) issued Technical Bulletin No. 98-1 ("GTB 98-1") *Disclosures About Year 2000 Issues*, effective for financial statements on which the auditors' report is dated after October 31, 1998. The provisions terminate for financial statements for periods ending after December 31, 1999 unless systems and other equipment are not year-2000 compliant as of the balance sheet date. GTB 98-1 requires that the financial statements discuss the year 2000 issue as it relates to the Fund. Such disclosure would include a description of the stages of work in process or completed as of June 30, 1999 to make computer systems and other electronic equipment critical to conducting operations year-2000 compliant. Any additional stages of work necessary to make such systems year-2000 compliant would also need to be disclosed.

Use of Estimates in the Preparation of Financial Statements - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Basis of Accounting - The Fund has been classified as a governmental proprietary fund type for accounting purposes. Generally, revenues are recorded when earned and expenses are recognized as incurred.

Cash and Investments - Effective July 1, 1997 the Department adopted GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, with retroactive application as of July 1, 1996 for reporting investments of the Fund. Accordingly, all investments are reported at fair value except for certain nonparticipating fixed interest investment contracts which are valued in accordance with GASB Statement No. 31 using cost based measures. The adoption of GASB Statement No. 31 resulted in an increase in retained earnings of the Fund at July 1, 1996 of \$7,526,000 and an increase in investment income for fiscal year ended June 30, 1997 of \$8,420,000. The fair value of investments is based on published market prices and quotations from major investment brokers and from the State of California for the Surplus Money Investment Fund. Uncommitted bond proceeds restricted for loans to veterans are reflected in the balance sheet as restricted cash and investments.

Receivables Under Contracts of Sale - Receivables under contracts of sale consist of the remaining contract principal balance plus unpaid interest accrued to date, net of the reserve for uncollectible accounts. The contract balance may also include amounts paid by the Fund for property taxes and insurance pending reimbursement from the contract holder.

Reserve for Uncollectible Accounts - The reserve for uncollectible accounts is established through a provision charged to operations. The reserve is an amount that management believes will be adequate to absorb losses inherent in existing contracts and commitments to extend credit, based on evaluations of the collectibility and prior loss experience of contracts and commitments to extend credit. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, specific problem contracts, commitments, and current and anticipated economic conditions that may affect the borrowers' ability to repay the obligation.

Other Real Estate Owned - Real estate acquired by repossession is carried at the lower of the contract balance or its net realizable value. After repossession, the value of the underlying contract is written down to the estimated fair value of the real estate, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of any related income, are included in other expenses.

On April 1, 1998, the Department instituted a loan guarantee fee on all loans with down payments less than 20%. Such loans are classified as high loan to value loans (HLTV). For eligible borrowers, the fee is used to purchase loan guarantees from the U.S. Department of Veterans Affairs (USDVA). For approximately 5,790 HLTV loans originated prior to purchasing USDVA loan guarantees, the Fund purchased primary mortgage insurance (PMI) from the Commonwealth Mortgage Assurance Company. The PMI provides lifetime coverage on the HLTV loans, not covered by USDVA loan guarantees, subject to a 3% deductible. The Department is responsible for any losses not covered by the USDVA loan guarantees or the PMI.

Insurance Claims Payable and Loss Reserves - Insurance claims payable and loss reserves include unpaid claims, incurred but not reported (INBR) claims and loss reserves for the Fire and Hazard Insurance Plan and the benefits payable under the Department's remaining self-insured life and disability protection plan.

Fire and Hazard Insurance - This insurance program is provided to eligible contract holders as part of the loan program. The difference between premiums charged to contract holders and claims and expenses incurred and the change in loss reserves is included as a net amount in the statement of revenues, expenses and changes in retained earnings.

Self-Insured Life and Disability Protection Plan - From January 1, 1984 to June 1, 1996, the Department operated a self-funded protection plan whereby life and disability insurance was provided to eligible contract holders. The Department's self-insured life and disability protection plan was terminated effective June 1, 1996. The life and disability benefits previously available to these members under the self-insured protection plan continue to be available to those contract holders who were receiving benefits at the time the plan was terminated. Loss reserves to satisfy these obligations of the protection plan which include future disability and life benefits were actuarially determined using a long-term discount rate of 7%. Significant actuarial assumptions and methodologies used to calculate the reserve are interest, mortality, disability and prepayment.

Amortization of Bond Premiums, Discounts and Issuance Costs - Premiums and discounts arising from the issuance of bonds are amortized on a method which approximates the effective interest method. Expenses incurred in connection with the issuance of bonds are capitalized and amortized using the straight-line method.

Retirement Plan - The Department adopted Statement No. 27 of the Governmental Accounting Standards Board, *Accounting for Pensions by State and Local Government Employers*, effective for the fiscal year ended June 30, 1997, and accordingly modified its footnote disclosure regarding its pension plan.

Reclassifications - Certain 1997 amounts have been reclassified to conform with the 1998 presentation.

## 2. CASH AND INVESTMENTS

Cash in the State Treasury of \$6,552,580 and \$12,772,900 as of June 30, 1998 and 1997, respectively, represents amounts held in the Fund's general operating accounts with the State Treasury. These monies are pooled with the monies of other State agencies and invested by the State Treasurer's office. These assets are not individually identifiable.

Investment of bond funds is restricted by applicable California law and the various bond resolutions associated with each issuance, generally, to certain types of investments, including direct obligations of the U.S. Government and its agencies, the State of California's Surplus Money Investment Fund, and investment agreements with financial institutions or insurance companies rated within the top two ratings of a nationally recognized rating service. The investments with the insurance administrator, held as a deposit in accordance with a master agreement for the remaining active life and disability insurance program for disabled contract holders, is authorized by California law. In addition, the Department has restricted \$5,000,000 plus interest accrued since February 1, 1998, for potential life and disability rate increases after January 31, 2002.

The Fund's four investments in master investment agreements totaling \$938,887,843 as of June 30, 1998 are carried at cost. The interest rates on investment agreements are fixed and range from 5.4% to 5.9%. The investment agreements expire from 1999 to 2032.

All of the Fund's investments in U.S. Treasury notes and bonds and the amounts administered by the insurance company are categorized as risk category 1, which is defined by GASB Statement No. 3 as investments that are insured or registered or for which the securities are held by the Fund or its agent in the Fund's name. In accordance with GASB Statement No. 3, the Fund's investments held in the State of California's Surplus Money Investment Fund, the investment agreements and the mutual fund are not categorized as to risk.

The Fund's investments at June 30, 1998 and 1997 are as follows (in thousands):

	1998 Fair Value	1997 Fair Value
<b>Category 1:</b>		
U.S. Treasury notes and bonds	\$ 187,851	\$ 346,014
Amounts held in trust fund with insurance administrators:		
U.S. Treasury notes	15,331	16,729
Corporate bonds	16,186	21,096
Other	4,378	7,689
<b>Investments Not Subject to Categorization:</b>		
State of California's Surplus Money Investment Fund	318,768	304,405
Investment agreements (at cost)	938,888	365,542
Amounts held in trust fund with insurance administrators:		
Mutual fund	<u>6,778</u>	<u>5,098</u>
	<u><b>\$1,488,180</b></u>	<u><b>\$1,066,573</b></u>

### 3. RECEIVABLES UNDER CONTRACTS OF SALE

The Fund retains title to all real property subject to contracts of sale until the contract is satisfied. The veteran's contracts have original terms of 25-30 years and bear interest at rates of 4.4% to 10.75%, depending on the age and type of contract and the classification of the current contract holder.



#### 4. BONDS PAYABLE

At June 30, 1998 and 1997, bonds payable included the following (in thousands):

	1998	1997
General obligation bonds of the State of California, annual interest rates from 4.1% to 11.0% due in varying annual installments through 2032 (subject to varying redemption provisions)	\$2,947,165	\$2,632,045
Home purchase revenue bonds, annual interest rates from 3.9% to 5.5%, due in varying annual installments through 2019 (subject to varying redemption provisions)	<u>275,055</u> 3,222,220	<u>327,580</u> 2,959,625
Discounts	(4,358)	(8,492)
Premiums	214	2,179
Unamortized bond origination costs	(11,454)	
Unamortized bond redemption premiums	<u>(12,096)</u>	<u>          </u>
Total	<u>\$3,194,526</u>	<u>\$2,953,312</u>

Future scheduled bond maturities at June 30, 1998 are as follows (in thousands):

1999	\$ 458,395
2000	223,790
2001	120,825
2002	124,660
2003	123,755
Thereafter	<u>2,170,795</u>
	<u>\$3,222,220</u>

General obligation bonds of the State of California are payable in accordance with the various veterans bond acts by the State General Fund. The full faith and credit of the State of California is pledged for the payment of both principal and interest. All general obligation bonds have an equal claim against the General Fund of the State of California. These bonds are included as obligations of the Fund when the proceeds from bond sales are received. The repayment for the bonds is the responsibility of the Fund. Authorized and unissued bonds under the Veterans Bond Acts of 1990 and 1996 at June 30, 1998 and 1997 were \$176,835,000 and \$654,370,000, respectively.

Revenue bonds are special obligations of the Department payable solely from, and by a pledge of, an undivided interest in the assets of the Veterans Farm and Home Building Fund of 1943 and the Veterans Debenture Revenue Fund, a separate fund of the Department. The undivided interest in the net revenues of the 1943 Fund is secondary and subordinate to any interest or right in the 1943 Fund of the people of the State of California and of the holders of general obligation veterans bonds. At any point in time, authorized and unissued revenue bonds equal the \$1.5 billion ceiling authorized in 1987 less revenue bonds outstanding at that time. At June 30, 1998 and 1997, authorized and unissued revenue bonds were \$1,224,945,000 and \$1,172,420,000, respectively.

In December 1997, the Department amended the revenue bond resolution provisions regarding the Bond Reserve Account in the Veterans Debenture Revenue Fund (a separate entity). The revenue bond resolution requires the establishment and maintenance of a Bond Reserve Account in an amount equal to at least three percent of the aggregate outstanding principal amount of all Revenue Bonds with interest rates fixed to maturity. To calculate the reserve requirement, the Ninth Supplemental Resolution established, with respect to the revenue bonds with interest rates fixed to maturity issued pursuant to such resolution (1997 Series A Bonds, 1997 Series B Bonds, and 1998 Series A Bonds), a requirement equal to at least seven percent of the outstanding principal amount of such Revenue Bonds. Amounts in the Bond Reserve Account shall be used solely for the purposes of paying the principal of and the interest on the Revenue Bonds and for making Mandatory Sinking Account Payments on Revenue Bonds. Amounts on deposit in the Bond Reserve Account as of any date, in excess of the bond reserve requirement, may be transferred out of the Veterans Debenture Revenue Fund to the Fund, at the request of the Department. Investment earnings of the Veterans Debenture Revenue Fund are transferred to the Fund. At June 30, 1998 and 1997, the total assets of the Veterans Debenture Revenue Fund are shown as a receivable of the Fund. Complete financial statements of the Veterans Debenture Revenue Fund, Department of Veterans Affairs, State of California can be obtained by contacting the California Department of Veterans Affairs.

## **5. BOND REFUNDING**

During the year ended June 30, 1998, the Department issued General Obligation bonds totaling \$1,338,635,000 and Home Purchase Revenue bonds totaling \$275,055,000 with an average interest rate of 5.35%. Certain bond proceeds from the bond issue were used to refund previously issued General Obligation bonds of \$753,695,000, and Home Purchase Revenue bonds of \$234,685,000. The remaining net proceeds are available for new Contracts of Purchase subject to the terms of the bonds.

The refunding of the General Obligation and Home Purchase Revenue bonds is expected to reduce the Department's debt service payments by approximately \$213,338,000 over the next 22 years and results in an economic gain based on the present value of the net savings of approximately \$132,457,000 as adjusted for issuance costs and redemption premiums.

For those refunded bonds that could not be called for immediate redemption, approximately \$310,486,000 was deposited in various escrow accounts held by the State Treasurer, as escrow trustee, to provide for all future debt service payments on the refunded bonds. As a result, these refunded bonds are considered to be defeased and the liability for those bonds has been removed from the Fund's balance sheet.

## **6. FIRE AND HAZARD INSURANCE**

Fire and hazard insurance coverage is provided on behalf of contract holders for substantially all properties subject to contracts of sale. The program is funded by amounts charged to contract holders which are considered appropriate to cover losses incurred, premiums paid for excess insurance coverage and administration fees. From the amounts charged to contract holders, the Department pays losses up to \$1,500,000 per occurrence or \$12,000,000 per policy year. Coverage in excess of the above amounts is provided under a master policy with an insurance carrier which also administers the program. The loss reserve is based on the third party administrators estimate of incurred but not reported claims based on the historical trends and loss experience within the portfolio.

The excess of premiums charged to contract holders over claims, expenses and change in loss reserves for the year ended June 30, 1998 and 1997 was as follows (in thousands):

	1998	1997
Amounts charged to contract holders	\$ 9,788	\$ 10,344
(Less) plus:		
Decrease in estimated loss reserve	29	1,339
Claims loss expense	(6,418)	(9,907)
Master policy premium	(532)	(622)
Administrative fees	<u>(781)</u>	<u>(828)</u>
Excess of amounts charged to contract holders over claims and expenses and changes in reserves	<u>\$ 2,086</u>	<u>\$ 326</u>

#### 7. SELF-INSURED LIFE AND DISABILITY PROTECTION PLAN

The Department was responsible for a self-insured life and disability protection plan for all contract holders until June 1, 1996. At that time, except for contract holders receiving benefits, the self-insured life and disability protection plan was replaced by an interim life and disability insurance plan provided by a commercial insurer, Pacific Mutual Group (PMG). Effective February 1, 1998, PMG was selected to provide a replacement, long-term life and disability plan.

As of June 30, 1998, the Department remains self-insured for approximately 1,249 remaining contract holders. Under the provisions of the self-insured plan benefits continue until the beneficiary returns to active employment, dies or their contract is paid off. Loss reserves for these obligations have been actuarially determined. A portion of the required loss reserves are maintained under a third party administrator (TPA) agreement and are shown in the financial statements as investments with insurance administrators. During the year, the TPA reserves have been used to satisfy benefits payable under the self-insured protection plan. Earnings on investments held by the TPA were \$2,976,337 and \$3,732,472 in 1998 and 1997, respectively, and are included in interest revenues - investments and other in the financial statements.

The excess of claims expenses, changes in loss reserves, and administrative expenses over plan revenues whose coverages continue as obligations of the self-funded life and disability protection plan for the years ended June 30, 1998 and 1997 was as follows (in thousands):

	1998	1997
Claims expenses:		
Life insurance program	\$ (1,836)	\$ (1,564)
Disability insurance program	<u>(11,510)</u>	<u>(10,843)</u>
Total claims expenses	(13,346)	(12,407)
Decrease in estimated loss reserves	<u>12,810</u>	<u>12,418</u>
Net claims expenses and change in loss reserves	(536)	11
Plus plan revenues:		
Life insurance program	157	205
Disability insurance program	<u>179</u>	<u>224</u>
Total	336	429
Less administrative fees	<u>(426)</u>	<u>(602)</u>
Excess of net claims expenses, change in loss reserves and administrative fees over plan revenues	<u>\$ (626)</u>	<u>\$ (162)</u>

## 8. COMMITMENTS AND CONTINGENCIES

As of June 30, 1998 and 1997, the Fund had loan commitments to veterans for the purchase of properties under contracts of sale of approximately \$16,017,616 and \$14,467,800, respectively.

The Department is a defendant in certain litigation related to the self-insured Life and Disability Protection Plan, formerly operated by the Department, and other matters. The Department, based on the advice of its counsel, believes that the suits are without merit and intends to vigorously defend its position. Management is of the opinion that the potential liability will not have a material adverse effect on the financial statements.

The Fund leases several buildings used as district offices. Rent expense for the years ended June 30, 1998 and 1997 was \$462,562 and \$482,057, respectively. Lease terms generally range from five to ten years with options to renew for additional periods. As of June 30, 1998, minimum annual rentals under operating leases are as follows (in thousands):

1999	\$ 412,241
2000	332,254
2001	278,040
2002	159,000
2003	98,463
Thereafter	<u>36,122</u>
	<u>\$1,316,120</u>

## 9. RETIREMENT PLAN

The Department, through the State of California, contributes to the California Public Employees Retirement System (CalPERS), which includes an agent multiple-employer public employee retirement system and a cost sharing multiple-employee plan that acts as a common investment and administrative agent for participating entities within the State of California. Substantially all full-time employees of the Fund are members of CalPERS. The Plan provides a monthly allowance based on age, years of credited service, and highest average compensation over an established period of time of one to three years. Vesting occurs after five to ten years. The Plan also provides death and disability benefits. The benefits are established by contract with CalPERS in accordance with the provisions of the Public Employees Retirement Law. CalPERS issues a publicly available Comprehensive Annual Financial Report (CAFR) that includes financial statements and required supplementary information for CalPERS. A copy of that report may be obtained by writing to CalPERS, Central Supply, P.O. Box 1802, Sacramento, CA 95812-1802.

Contributions to the Plan are funded by both the Department and the employee, and are actuarially determined by CalPERS based on covered compensation. State employees, with the exception of employees in the second-tier plan, are required to contribute to the fund. The contribution rates of active plan members are based on a percentage of salary over a monthly base compensation amount of \$238 to \$863. With the exception of employees in the second-tier plan, state employees' required contributions vary from 5% to 8% of their salary over their base compensation amount.

Contributions by the Department to the Plan for the years ended June 30, 1998 and 1997 were approximately \$956,000 and \$1,042,000, or approximately 8.4% and 9.2% of participants salaries, respectively. Employee contributions to the Plan for the years ended June 30, 1998 and 1997 were approximately \$281,000 and \$305,000 or approximately 2.5% and 2.7% of participant's salaries, respectively.

For fiscal years ended June 30, 1998 and 1997, the Department's annual pension cost was equal to the Department's required and actual contributions. The required contribution was determined as part of the June 30, 1996 actuarial valuation using the entry age normal actuarial cost method. The actuarial assumptions included (a) 8.5% investment rate of return, and (b) projected salary increases that vary by duration of service. Both (a) and (b) included an inflation component of 4.5%. The actuarial value of the Department's assets was determined using techniques that smooth the effects of short-term volatility in the market value of investments over a five-year period. The underfunded actuarial accrued liability is being amortized as a level percentage of projected payroll on a closed basis. The remaining amortization period at June 30, 1996 was 34 years. Three-year fund trend information is as follows:

### Three-Year Fund Trend Information

Fiscal Year-End	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
June 30, 1996	\$987,000	100%	\$0
June 30, 1997	\$1,042,000	100%	\$0
June 30, 1998	\$956,000	100%	\$0

The most recent actuarial valuation of CalPERS indicated that there was an unfunded liability for vested benefits due current employee participants in the plan. The amount of the unfunded liability applicable to each agency or department cannot be determined. Trend information, which presents CalPERS progress in accumulating sufficient assets to pay benefits when due is presented in the June 30, 1997 CalPERS CAFR.

Since all state agencies and departments are considered by CalPERS collectively as a single employer, the actuarial value of plan assets, the actuarial accrued liability, the total unfunded liability, the actuarial value of assets as a percentage of the actuarial accrued liability, and the ratio of unfunded actuarial liability to annual covered payroll attributable to the Department's employees, whose compensation is paid from the Fund, cannot be determined.

#### **10. SUBSEQUENT EVENT**

During August 1998, the Fund called approximately \$57,600,000 of general obligation bonds pursuant to the terms and early call provisions of the bond agreements.

\* \* \* \* \*

**EXHIBIT B**

**FINANCIAL STATEMENTS OF  
THE VETERANS DEBENTURE REVENUE FUND  
FOR FISCAL YEARS 1998 AND 1997  
AND INDEPENDENT AUDITOR'S REPORT**

**VETERANS DEBENTURE REVENUE FUND  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

Financial Statements for the Years Ended June 30, 1998 and 1997 and  
Independent Auditors' Report

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# Deloitte & Touche



**Deloitte & Touche LLP**  
Suite 2000  
400 Capital Mall  
Sacramento, California 95814-4424

Telephone: (916) 498-7100  
Facsimile: (916) 444-7963

## INDEPENDENT AUDITORS' REPORT

California Veterans Board  
State of California  
Sacramento, California

We have audited the accompanying balance sheets of the Veterans Debenture Revenue Fund, Department of Veterans Affairs of the State of California (Fund) as of June 30, 1998 and 1997 and the related statements of revenues and expenses, and of cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Veterans Debenture Revenue Fund and are not intended to present the financial position of the Department of Veterans Affairs of the State of California and the results of its operations and cash flows of its proprietary fund types.

In our opinion, such financial statements referred to above present fairly, in all material respects, the financial position of the Veterans Debenture Revenue Fund, Department of Veterans Affairs of the State of California as of June 30, 1998 and 1997, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note 1 to the financial statements, in 1998 the Department of Veteran Affairs of the State of California, changed its method of accounting for investments of the Fund to conform with Governmental Accounting Standards Board Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, and, retroactively, restated its 1997 financial statements for the change.

*Deloitte + Touche LLP*

October 9, 1998

**Deloitte Touche  
Tohmatsu**

**VETERANS DEBENTURE REVENUE FUND  
DEPARTMENT OF VETERANS AFFAIRS,  
STATE OF CALIFORNIA**

**BALANCE SHEETS  
JUNE 30, 1998 AND 1997**

	<b>1998</b>	<b>1997 (as restated, see Note 1)</b>
<b>RESTRICTED ASSETS:</b>		
Cash in State Treasury	\$ 478	
Investments in State of California's Surplus Money Investment Fund (at fair value)	438,000	\$ 9,260,000
Investment agreement (at cost)	5,251,650	45,000,000
Investments in U.S. Treasury notes and bonds (at fair value)	6,875,000	31,200,000
Interest receivable:		
State of California's Surplus Money Investment Fund	40,270	297,252
U.S. Treasury notes and bonds	52,918	295,313
Investment contract	<u>27,301</u>	<u>1,426,019</u>
Total interest receivable	<u>120,489</u>	<u>2,018,584</u>
<b>TOTAL RESTRICTED ASSETS</b>	<b><u>\$12,685,617</u></b>	<b><u>\$87,478,584</u></b>
<b>LIABILITIES:</b>		
Income from investments due to the Veterans Farm and Home Building Fund of 1943	\$ 431,767	\$ 3,218,584
Bond reserve due to the Veterans Farm and Home Building Fund of 1943	<u>12,253,850</u>	<u>84,260,000</u>
<b>TOTAL LIABILITIES</b>	<b><u>\$12,685,617</u></b>	<b><u>\$87,478,584</u></b>

See notes to financial statements.

**VETERANS DEBENTURE REVENUE FUND**  
**DEPARTMENT OF VETERANS AFFAIRS,**  
**STATE OF CALIFORNIA**

**STATEMENTS OF REVENUES AND EXPENSES**  
**YEARS ENDED JUNE 30, 1998 AND 1997**

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	<b>1998</b>	<b>1997</b> <b>(as restated,</b> <b>see Note 1)</b>
<b>REVENUES:</b>		
Income from investments	\$3,390,303	\$12,042,851
Gain on sale of securities	5,124,173	
<b>EXPENSES</b>	<u>—</u>	<u>—</u>
<b>EXCESS OF REVENUES OVER EXPENSES</b> <b>BEFORE OPERATING TRANSFERS</b>	8,514,476	12,042,851
<b>OPERATING TRANSFERS OUT:</b>		
Veterans Farm and Home Building Fund of 1943	<u>8,441,491</u>	<u>10,842,851</u>
<b>EXCESS OF REVENUES OVER EXPENSES AND</b> <b>OPERATING TRANSFERS OUT</b>	<u>\$ 72,985</u>	<u>\$ 1,200,000</u>

See notes to financial statements.

**VETERANS DEBENTURE REVENUE FUND  
DEPARTMENT OF VETERANS AFFAIRS,  
STATE OF CALIFORNIA**

**STATEMENTS OF CASH FLOWS  
YEARS ENDED JUNE 30, 1998 AND 1997**

	<b>1998</b>	<b>1997 (as restated, see Note 1)</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Excess of revenues over expenses and operating transfers out	\$ 72,985	\$ 1,200,000
Adjustments to reconcile to net cash used by operating activities:		
Effect of changes in assets and liabilities:		
Interest receivable	1,898,095	708,664
Income from investments due to the Veterans Farm and Home Building Fund of 1943	(2,859,802)	(862,466)
Bond reserve due to the Veterans Farm and Home Building Fund of 1943	<u>(72,006,150)</u>	<u>(50,000,000)</u>
Net cash used by operating activities	<u>(72,894,872)</u>	<u>(48,953,802)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Decrease in investment securities	<u>72,895,350</u>	<u>48,952,357</u>
Net cash provided by investing activities	72,895,350	48,952,357
<b>NET INCREASE (DECREASE) IN CASH IN STATE TREASURY</b>	478	(1,445)
<b>CASH IN STATE TREASURY:</b>		
Beginning of year	<u>-</u>	<u>1,445</u>
End of year	<u>\$ 478</u>	<u>\$ -</u>

See notes to financial statements.

**VETERANS DEBENTURE REVENUE FUND  
DEPARTMENT OF VETERANS AFFAIRS,  
STATE OF CALIFORNIA**

**NOTES TO FINANCIAL STATEMENTS  
YEARS ENDED JUNE 30, 1998 AND 1997**

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**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Description of the Fund - The California Department of Veterans Affairs (the Department) is a separate legal entity, acting as a Cabinet level agency of the State of California. A seven-member California Veterans Board (the Board) has policy oversight of the operations of the Department. The Board's membership consists of the Department Secretary and six members, all of whom are appointed by the Governor, subject to confirmation by the State Senate. The Department is authorized to issue revenue bonds to fund low-interest farm and home loan contracts with veterans living in California.

In December 1997, the Department amended the revenue bond resolution provisions regarding the Bond Reserve Account in the Veterans Debenture Revenue Fund. The revenue bond resolution requires the establishment and maintenance of a Bond Reserve Account in an amount equal to three percent of the aggregate outstanding principal amount of all Revenue Bonds with interest rates fixed to maturity. To calculate the reserve requirement, the Ninth Supplemental Resolution established, with respect to the revenue bonds with interest rates fixed to maturity issued pursuant to such resolution (1997 Series A Bonds, 1997 Series B Bonds, and 1998 Series A Bonds), a requirement equal to at least seven percent of the outstanding principal amount of such Revenue Bonds. Amounts in the Bond Reserve Account shall be used solely for the purposes of paying the principal of and the interest on the Revenue Bonds and for making Mandatory Sinking Account Payments on Revenue Bonds. Amounts on deposit in the Bond Reserve Account in excess of the bond reserve requirement, may be transferred out of the Veterans Debenture Revenue Fund to the Veterans Farm and Home Building Fund of 1943 (Farm and Home Fund), at the request of the Department. Investment earnings of the Veterans Debenture Revenue Fund are transferred to the Farm and Home Fund.

At June 30, 1998 and 1997, the liabilities of the Veterans Debenture Revenue Fund represent amounts due to the Farm and Home Fund and, accordingly, are included as a receivable in the financial statements of the Farm and Home Fund.

The financial statements represent only the activities of the Veterans Debenture Revenue Fund (Fund) and are not intended to present the financial position of the Department of Veterans Affairs of the State of California and the results of its operations and cash flows of its proprietary fund types. The financial statements of the Fund are included in the financial statements of the State of California as the State represents the primary government and has ultimate oversight responsibility for the Fund.

New Accounting Pronouncements - The Governmental Accounting Standards Board (GASB) issued Technical Bulletin No. 98-1 ("GTB 98-1") *Disclosures About Year 2000 Issues* effective for financial statements on which the auditors' report is dated after October 31, 1998. The provisions terminate for financial statements for periods ending after December 31, 1999 unless systems and other equipment are not year 2000 compliant as of the balance sheet date. GTB 98-1 requires that the financial statements discuss the year 2000 issue as it relates to the Fund. Such disclosure would include a description of the stages of work in process or completed as of June 30, 1999 to make computer systems and other electronic equipment critical to conducting operations year-2000 compliant. Any additional stages of work necessary to make such systems year-2000 compliant would also need to be disclosed.

Use of Estimates in the Preparation of Financial Statements - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Basis of Accounting - The fund has been classified as a governmental proprietary fund type for accounting purposes. Generally, revenues are recorded when earned and become measurable, and expenses are recognized as incurred.

Cash and Investments - Effective July 1, 1997 the Department adopted GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, with retroactive application as of July 1, 1996 for reporting investments of the Fund. Accordingly, all investments are reported at fair value except for a nonparticipating fixed interest investment contract which is valued in accordance with GASB Statement No. 31 using cost based measures. The adoption of GASB Statement No. 31 resulted in an increase in income from investments and in income from investments due to the Veterans Farm and Home Building Fund of 1943 for fiscal year ended June 30, 1997 of \$1,200,000. The fair value of investments is based on published market prices and quotations from major investment brokers and from the State of California for the Surplus Money Investment Fund.

Revenues and Operating Transfers - Income from investments are recorded as earned. A corresponding operating transfer out is recorded to reflect the required transfer to the Farm and Home Fund.

Restricted Assets - Assets are restricted for paying the principal, interest and mandatory sinking account payments on revenue bonds (if no other monies within the Farm and Home Fund are available) or retiring all revenue bonds then outstanding.

## 2. CASH AND INVESTMENTS

Cash in State Treasury of \$478 as of June 30, 1998 represents amounts held in the Fund's general operating account with the State Treasury. These monies are pooled with the monies of other state agencies and invested by the State Treasurer's office. These investments are not individually identifiable.

Investment of bond funds is restricted by applicable California law and the various bond resolutions associated with each issuance, generally, to certain types of investments, including direct obligations of the U.S. Government and its agencies, the State of California's Surplus Money Investment Fund, and investment agreements with financial institutions rated within the top two ratings of a nationally recognized rating service.

The Fund's investment in the investment agreement of \$5,251,650 as of June 30, 1998 is carried at cost. The investment agreement is a fixed rate contract with interest at 5.75% which expires in the year 2022.

All of the Fund's investments in U.S. Treasury notes and bonds are categorized as risk category 1, which is defined by the GASB Statement No. 3 as investments that are insured or registered or for which the securities are held by the Fund or its agent in the Fund's name. In accordance with GASB Statement No. 3, the Fund's investments held in the State of California's Surplus Money Investment Fund and the investment agreement are not categorized as to risk.

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## EXHIBIT C

### MANDATORY SINKING ACCOUNT PAYMENTS

<u>Date</u> <u>(December 1)</u>	<u>1999A 2019</u> <u>Term Bonds</u>	<u>1999A 2027</u> <u>Term Bonds</u>	<u>1999B 2019</u> <u>Term Bonds</u>	<u>1999B 2028</u> <u>Term Bonds</u>
2018	\$4,230,000		\$6,255,000	
2019	4,460,000†		6,585,000†	
2020		\$4,690,000		\$ 6,935,000
2021		4,945,000		7,305,000
2022		5,205,000		7,695,000
2023		5,480,000		8,100,000
2024		5,770,000		8,525,000
2025		6,080,000		8,985,000
2026		6,710,000		10,855,000
2027		6,600,000†		8,830,000
2028				6,015,000†

† Stated maturity.

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## EXHIBIT D

### SUMMARY OF CERTAIN PROVISIONS OF THE MASTER CONTINUING DISCLOSURE UNDERTAKING

*Certain provisions of the Master Continuing Disclosure Undertaking of the Department not previously discussed in this Official Statement are summarized below. This summary does not purport to be complete or definitive and is qualified in its entirety by reference to the full terms of the Master Continuing Disclosure Undertaking.*

The Master Continuing Disclosure Undertaking, dated December 29, 1997, was executed and delivered by the Department for the benefit of the Bondowners and the Beneficial Owners and in order to assist the Participating Underwriters in complying with SEC Rule 15c2-12(b)(5). The Offered Revenue Bonds are Subject Bonds.

#### **Certain Definitions**

Defined terms used in the Master Continuing Disclosure Undertaking and not otherwise defined therein have the meanings set forth in the Resolution.

**"Beneficial Owner"** means a Beneficial Owner of Subject Bonds, as determined pursuant to the Rule.

**"Bonds"** means, at any time, all of the Department's then Outstanding Home Purchase Revenue Bonds, collectively.

**"Fiscal Year"** means that period established by the Department with respect to which its, as applicable, Audited Financial Statements or Unaudited Financial Statements are prepared. As of the date of the Master Continuing Disclosure Undertaking, the Department's Fiscal Year begins on July 1 and ends on June 30 of the next calendar year.

**"Bondowners"** means the registered owners of the Subject Bonds.

**"Listed Event"** means any of the events listed below under the heading "Reporting of Certain Events".

**"MSRB"** means the Municipal Securities Rulemaking Board established pursuant to Section 15B(b)(1) of the Securities Exchange Act of 1934.

**"Notice"** means written notice, sent for overnight delivery via the United States Postal Service or a private delivery service which provides evidence of delivery.

**"Notice Address"** means with respect to the Department:

State of California Department of Veterans Affairs  
1227 O Street  
Sacramento, CA 95814  
Attention: Bond Finance Division

**"NRMSIR"** means, at any time, a then-existing nationally recognized municipal securities information repository, as recognized from time to time by the SEC for the purposes referred to in the Rule.

**"Official Statement"** means the Official Statement of the Department dated December 10, 1997 with respect to the Department's Home Purchase Revenue Bonds, 1997 Series A, 1997 Series B, 1997 Series C, and 1998 Series A.

**"Participating Underwriter"** means any of the original underwriters of any Subject Bonds required to comply with the Rule in connection with the offering of such Subject Bonds.

**"Rule"** means the applicable provisions of Rule 15c2-12 promulgated by the SEC under the Securities Exchange Act of 1934, as amended (17 CFR Part 240, §240.15c2-12), as in effect on the date of the Master Continuing Disclosure Undertaking including any official interpretations thereof.

**"SEC"** means the United States Securities and Exchange Commission.

**"Securities Counsel"** means legal counsel expert in Federal securities laws.

**"SID"** means, at any time, a then-existing state information depository, if any, as operated or designated as such by or on behalf of the State and recognized by the SEC for the purposes referred to in the Rule.

**"Subject Bonds"** means those Bonds with respect to which the terms of the Master Continuing Disclosure Undertaking are expressly incorporated into any one of the Department documents authorizing the issuance of such Bonds.

### **Provision of Annual Financial Information**

The Department will, not later than the first day of the tenth calendar month after the end of each of the Department's Fiscal Years, commencing with the report for the 1996-1997 Fiscal Year, provide to the Trustee and to each NRMSIR and the SID the Annual Financial Information. The audited financial statements of the Department and of the Bond Reserve Account and Loan Loss Account may be submitted separately from the balance of the Annual Financial Information, and later than the date required for the filing of the Annual Financial Information if not available by that date.

The Master Continuing Disclosure Undertaking requires the Department to provide, in a timely manner, notice of any failure by it to provide Annual Financial Information to each NRMSIR and the SID on or before the date described in the first paragraph under this heading, to the SID, to the Trustee and to either (i) each NRMSIR or (ii) the MSRB.

### **Content of Annual Financial Information**

The Department's Annual Financial Information shall contain or include by reference the following:

(a) the audited financial statements of the 1943 Fund and of the Bond Reserve Account and Loan Loss Account for the Fiscal Year ended on the previous June 30, prepared in accordance with generally accepted accounting principles established by the Financial Accounting Standards Board, if available, or unaudited financial statements for such Fiscal Year; and

(b) financial information or operating data of the types included in Exhibit D of the Official Statement entitled "Certain Department Financial Information and Operating Data."\*

If not provided as part of the Annual Financial Information by the date required (as described above under "Provision of Annual Financial Information"), the Department shall provide audited financial statements, when and if available, to the Trustee and to each NRMSIR and the SID.

Any or all of the items listed above may be included by specific reference to other documents, including of fiscal statements of debt issues of the Department or related public entities, which have been submitted to each NRMSIR and the SID or the SEC. (If such document is an official

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\* Such information or data is substantially similar to that included in Exhibit E of this Official Statement.

statement, it must also be available from the MSRB.) Annual Financial Information may be provided in one document or multiple documents, and at one time or in part from time to time.

### **Reporting of Certain Events**

The Department will give notice to the Trustee and to the SID and to either each NRMSIR or the MSRB of the occurrence of any of the following events with respect to the Subject Bonds, if material:

As of the date of this Official Statement, there is no SID.

- (1) principal and interest payment delinquencies;
- (2) non-payment related defaults;
- (3) modification to rights of Bondowners;
- (4) Subject Bond calls;
- (5) unscheduled draws on credit enhancements reflecting financial difficulties;
- (6) substitution of credit or liquidity providers, or their failure to perform;
- (7) defeasances;
- (8) rating changes;
- (9) adverse tax opinions or events affecting the tax-exempt status (if applicable) of any Subject Bonds;
- (10) unscheduled draws on the debt service reserves reflecting financial difficulties; or
- (11) release, substitution or sale of property securing repayment of the Subject Bonds.

### **Additional Information**

Nothing in the Master Continuing Disclosure Undertaking will be deemed to prevent the Department from disseminating any other information, using the means of dissemination set forth in the Master Continuing Disclosure Undertaking or any other means of communication, or including any other information in any Annual Financial Information or notice of occurrence of a Listed Event, in addition to that which is required by the Master Continuing Disclosure Undertaking. If the Department chooses to include any information in any Annual Financial Information or notice of occurrence of a Listed Event in addition to that which is specifically required by the Master Continuing Disclosure Undertaking, the Department will have no obligation under the Master Continuing Disclosure Undertaking to update such information or include it in any future Annual Financial Information or notice of occurrence of a Listed Event.

### **Amendment of Master Continuing Disclosure Undertaking**

The Master Continuing Disclosure Undertaking may be amended and any provision of the Master Continuing Disclosure Undertaking be waived, without the consent of the Bondowners or Beneficial Owners, except as described in clause 4(ii) below, under the following conditions: (1) such amendment or waiver is made in connection with a change in circumstances that arises from a change in legal (including regulatory) requirements, a change in law (including rules or regulations) or in interpretations thereof, or a change in the identity, nature, or status of the Department or the type of business conducted thereby, (2) the Master Continuing Disclosure Undertaking as so amended or waived would have complied with the requirements of the Rule as of the date of each primary offering of Subject Bonds affected by such amendment or waiver, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances, (3) the Department shall have delivered to the Trustee an opinion of Securities Counsel, addressed to

the Department and the Trustee, to the same effect as set forth in clause (2) above, (4) either (i) a party unaffiliated with the Department (such as the Trustee or bond counsel), acceptable to the Trustee and the Department, has determined that the amendment or waiver does not materially impair the interests of the Beneficial Owners, or (ii) the Bondowners consent to the amendment to or waiver of the Master Continuing Disclosure Undertaking pursuant to the same procedures as are required for amendments to the Resolution with consent of Bondowners, and (5) the Department shall have delivered copies of such amendment or waiver to the SID, to the Trustee, and to either each NRMSIR or the MSRB.

In addition to the foregoing, the Department may amend the Master Continuing Disclosure Undertaking, and any provision of the Master Continuing Disclosure Undertaking may be waived, if the Trustee shall have received an opinion of Securities Counsel, addressed to the Department and the Trustee, to the effect that the adoption and the terms of such amendment or waiver would not, in and of themselves, cause the undertakings in the Master Continuing Disclosure Undertaking to violate the Rule, taking into account any subsequent change in or official interpretation of the Rule.

#### **Benefit; Enforcement**

The provisions of the Master Continuing Disclosure Undertaking will inure solely to the benefit of the Bondowners and Beneficial Owners from time to time.

*Except* as described in this paragraph, the provisions of the Master Continuing Disclosure Undertaking will create no rights in any other person or entity. The obligation of the Department to comply with the provisions of the Master Continuing Disclosure Undertaking are enforceable (i) in the case of enforcement of obligations to provide financial statements, financial information, operating data, and notices, by any Beneficial Owner of Outstanding Subject Bonds, or by the Trustee on behalf of the Bondowners of Outstanding Subject Bonds, or (ii) in the case of challenges to the adequacy of the financial statements, financial information, and operating data so provided, by the Trustee on behalf of the Bondowners of Outstanding Subject Bonds or by any Beneficial Owner; *provided, however*, that a Beneficial Owner may not take any enforcement action pursuant to clause (ii) without the consent of the Bondowners of not less than 20% in aggregate principal amount of the Subject Bonds at the time Outstanding.

The right to enforce the provisions of the Master Continuing Disclosure Undertaking is limited to a right, by action in mandamus or for specific performance, to compel performance of the Department's obligations under the Master Continuing Disclosure Undertaking. Any failure by the Department to perform in accordance with the Master Continuing Disclosure Undertaking will not constitute a default or an Event of Default under the Resolution, and the rights and remedies provided by the Resolution upon the occurrence of a default or an Event of Default will not apply to any such failure.

#### **Termination of Reporting Obligation**

The Department's obligations under the Master Continuing Disclosure Undertaking with respect to the Subject Bonds terminate upon the legal defeasance under the Resolution, prior redemption, or payment in full of all of the Subject Bonds. The Department shall give notice of any such termination to the SID and to either each NRMSIR or the MSRB.

The Master Continuing Disclosure Undertaking, or any provision thereof, will be null and void to the extent set forth in the opinion of Securities Counsel described in clause (1) in the event that the Department (1) delivers to the Trustee an opinion of Securities Counsel, addressed to the Department and the Trustee, to the effect that those portions of the Rule which require the provisions of the Master Continuing Disclosure Undertaking, or any of such provisions, do not or

no longer apply to the Subject Bonds, whether because such portions of the Rule are invalid, have been repealed, or otherwise, as will be specified in such opinion, and (2) delivers notice to such effect to the Trustee, to the SID and to either each NRMSIR or the MSRB.

**Governing Law**

The Master Continuing Disclosure Undertaking will be construed and interpreted in accordance with the laws of the State, and any suits and actions arising out of the Master Continuing Disclosure Undertaking will be instituted in a court of competent jurisdiction in the State, *provided that*, to the extent the Master Continuing Disclosure Undertaking addresses matters of Federal securities laws, including the Rule, the Master Continuing Disclosure Undertaking will be construed in accordance with such Federal securities laws and of fiscal interpretations thereof.

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## EXHIBIT E

### CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA

#### Contracts of Purchase

Set forth below is certain financial information regarding Contracts of Purchase.

#### *Existing Contracts of Purchase*

The following charts describe the current loan to value ratios and geographic distribution of Contracts of Purchase financed under the Program as to November 30, 1998, using proceeds of Veterans G.O. Bonds and Revenue Bonds.

#### Current Loan-to-Value Ratio of Contracts of Purchase<sup>(1)</sup>

	Uninsured (000s)	CMAC Insured (000s)	In Process for CMAC Insurance (000s)	VA Guaranteed (000s)	Total (000s)
<b>Single Family Homes</b>					
Less than 30% LTV .....	\$ 111,998	—	—	—	\$ 111,998
30-49% LTV .....	269,590	\$ 135	—	\$ 55	269,780
50-59% LTV .....	192,572	—	—	—	192,572
60-69% LTV .....	222,100	221	—	—	222,321
70-79% LTV .....	260,540	10,206	—	125	270,871
Sub-total .....	\$1,056,800	\$ 10,562	—	\$ 180	\$1,067,542
80-84% LTV .....	\$ 11,245	\$113,915	\$ 10,008	\$ 1,023	\$ 136,191
85-89% LTV .....	17,076	237,754	18,228	2,678	275,736
90-94% LTV .....	43,205	310,235	49,852	10,753	414,045
95-97% LTV .....	5,458	4,802	27,095	15,322	52,677
Sub-total .....	\$ 76,984	\$666,706	\$105,183	\$29,776	\$ 878,649
Other High LTV Loans <sup>(2)</sup> .....	\$ 14,577	\$ 1,487	—	—	\$ 16,064
Total .....	\$1,148,361	\$678,755	\$105,183	\$29,956	\$1,962,255
<b>Other Property Types</b>					
Farms .....	\$ 6,161	—	—	—	\$ 6,161
Mobile Homes in Parks .....	11,154	—	—	—	11,154
Total .....	\$ 17,315	—	—	—	\$ 17,315
<b>Special Status</b>					
<b>Contracts of Purchase</b>					
Real Estate Owned <sup>(3)</sup> .....	\$ 49,183	\$ 1,610	—	—	\$ 50,793
Disability Program <sup>(4)</sup> .....	41,173	—	—	—	41,173
Total .....	\$ 90,356	\$ 1,610	—	—	\$ 91,966
Total Portfolio .....	\$1,256,032	\$680,365	\$105,183	\$29,956	\$2,071,536

(1) LTV based on current Contracts of Purchase balance (net of accrued interest, advanced taxes and insurance) divided by original appraised value of property.

(2) Consists of Contracts of Purchase where delinquent accrued interest and charges have been added to Contracts of Purchase balance.

(3) Repossessed properties and delinquent Contracts of Purchase carried as REO on financial statements.

(4) Contracts of Purchase where payments are made on behalf of veterans by the Department's life and disability coverage plan.

## Geographic Distribution of Contracts of Purchase

<u>County</u>	<u>Approximate Current Contract Balance (000s)</u>
Sacramento .....	\$ 220,585
Los Angeles .....	161,864
San Bernardino .....	156,355
San Diego .....	121,350
Fresno .....	114,985
Kern .....	107,757
Riverside .....	102,026
Orange .....	96,558
Placer .....	61,689
San Joaquin .....	60,583
Solano .....	55,960
Shasta .....	51,566
Contra Costa .....	48,985
Other Northern California Counties .....	403,137
Other Central California Counties .....	247,003
Other Southern California Counties .....	61,133
Statewide—California .....	<u>\$2,071,536</u>

### *Contracts of Purchase Origination and Principal Repayment Experience*

The following tables represent, respectively, a historical picture of Contract of Purchase originations since the 1984-85 fiscal year and selected principal repayments with respect to Contracts of Purchase since the 1977-1978 fiscal year.

#### New Contracts of Purchase During the Fiscal Year<sup>(1)</sup>

<u>Fiscal Year Ending June 30</u>	<u>Veterans G.O. Bonds</u>		<u>Unrestricted Funds</u>		<u>Revenue Bonds</u>		<u>Total</u>	
	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>
1985 .....	4,196	\$290,885,900			2,301	\$154,244,600	6,497	\$445,130,500
1986 .....	3,484	243,955,800			2,401	160,782,200	5,885	404,738,000
1987 .....	1,569	108,789,700			1,160	75,836,800	2,729	184,626,500
1988 .....	2,958	236,054,500			1,397	99,040,900	4,355	335,095,400
1989 .....	3,112	252,796,300			1,154	83,076,100	4,266	335,872,400
1990 .....	2,097	187,445,600			522	38,150,800	2,619	225,596,400
1991 .....	1,927	200,393,500			359	29,189,600	2,286	229,583,100
1992 .....	1,086	111,600,500			388	34,671,600	1,474	146,272,100
1993 .....	740	94,417,100			286	27,443,800	1,026	121,860,900
1994 .....	843	117,213,779			337	34,740,536	1,180	151,954,315
1995 .....	2,109	286,178,376			822	84,860,894	2,931	371,039,270
1996 .....	762	107,751,444			222	22,723,617	984	130,475,061
1997 .....	766	118,344,636			201	21,853,933	967	140,198,569
1998 .....	615	99,224,002	188	17,716,376	164	18,871,066	967	135,811,444
1999 <sup>(2)</sup> .....	359	59,490,149	260	38,238,379	95	11,446,503	714	109,175,031

(1) Number of new Contracts of Purchase does not include home improvement loans.

(2) 5-month period through November 30, 1998.

**Selected Principal Flows with respect to Contracts of Purchase  
Funded by both Veterans G.O. Bonds and Revenue Bonds**

Fiscal Year Ending June 30	Contracts Funded During Year (000s)	Contract Prepayments During Year (000s)	Other Principal Receipts-Losses During Year (000s)	Contract Balance at End of Year (000s)	Average Base Contract Rate	Average of	Annual Average Prepayment Rate	Annual Average Origination Rate
						Monthly FHLMC		
						30-year Conventional Loan Rate		
Principal Flows					Rates			
1978.....	—	—	—	\$1,538,524	—%	—%	—%	—%
1979.....	\$ 340,227	\$ 124,864	\$ 68,240	1,685,647	5.6	—	7.7	21.1
1980.....	716,662	100,540	69,079	2,232,690	5.6	—	5.1	36.6
1981.....	417,628	82,393	70,472	2,497,453	6.6	14.0	3.5	17.7
1982.....	279,239	44,608	74,891	2,657,193	7.3	17.3	1.7	10.8
1983.....	254,086	92,146	87,536	2,731,597	8.0	14.6	3.4	9.4
1984.....	405,616	132,911	94,930	2,909,372	8.0	13.4	4.7	14.4
1985.....	445,131	123,669	88,308	3,142,526	8.0	13.8	4.1	14.7
1986.....	404,738	179,809	94,970	3,272,485	8.0	11.5	5.6	12.6
1987.....	184,627	261,675	99,569	3,095,868	7.7	9.8	8.2	5.8
1988.....	335,095	198,396	114,178	3,118,389	7.0	10.5	6.4	10.8
1989.....	335,872	207,471	105,896	3,140,894	7.3	10.6	6.6	10.7
1990.....	225,596	232,085	96,639	3,037,766	8.0	10.1	7.5	7.3
1991.....	229,583	191,895	92,722	2,982,732	8.0	9.9	6.4	7.6
1992.....	146,272	246,150	92,975	2,789,879	8.0	9.0	8.5	5.1
1993.....	121,861	273,817	105,629	2,532,294	8.0	8.0	10.3	4.6
1994.....	151,954	359,749	98,773	2,225,726	8.0	7.3	15.1	6.4
1995.....	371,039	111,984	74,706	2,410,075	7.8	8.7	4.8	16.0
1996.....	130,475	141,767	92,521	2,306,262	8.0	7.5	6.0	5.5
1997.....	140,199	111,254	106,027	2,229,180	8.0	7.9	4.9	6.2
1998.....	135,812	172,134	94,106	2,098,752	7.7	7.2	8.0	6.3
1999 <sup>(1)</sup> .....	109,175	75,270	61,121	2,071,536	7.0	6.8	8.7	12.6
	\$5,880,887	\$3,464,587	\$1,883,288					

(1) 5-month period through November 30, 1998.

### **Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments**

The following table shows amounts expected to become available to fund Contracts of Purchase following the expected issuance of the 1999 Veterans G.O. Bonds and the Offered 1999 Revenue Bonds. The table includes bonds issued at short-term rates, the proceeds of which will not become available to finance Contracts of Purchase until the interests rates are adjusted to fixed interest rates to maturity. The universe of veterans eligible to receive Contracts of Purchase financed by the different classifications of available moneys is described under "THE PROGRAM—Qualifying Veteran Status." Additional moneys may become available to finance Contracts of Purchase through the future issuances of Veterans G.O. Bonds and Revenue Bonds. The Department has full discretion to use moneys available from prior, current or future bond issues in any order of priority it chooses. As of November 30, 1998, the Department had 327 pending applications for Contracts of Purchase in the aggregate amount of approximately \$51,041,306.

\$51,041,300.

		Respective Series Bond Proceeds Subaccounts				
Bond Series	Balance as of	Unrestricted Moneys <sup>(1)</sup>	Qualified Veterans Mortgage Bond Proceeds <sup>(1)</sup>	Qualified Mortgage Bond Proceeds <sup>(1)</sup>	Investment	Investment Rate (%)
<b>Existing Veterans G.O. Bonds</b>						
Series BG, BH, BK, BL . . . . .	11/30/98	-0-	\$101,435	-0-	Soc Gen <sup>(2)(3)</sup>	5.710
Series BM, BN . . . . .	11/30/98	\$ 164	-0-	-0-	FCMSI <sup>(5)</sup>	5.620
Series BP . . . . .	11/30/98	-0-	14,000	-0-	Trinity <sup>(6)</sup>	5.702
1954 Code G.O. Bond Series						
Recycling Subaccount . . . . .	11/30/98	-0-	21,462	-0-	Soc Gen <sup>(2)(3)</sup>	5.710
Unrestricted G.O. Bond Series						
Recycling Subaccount 1 . . . . .	11/30/98	66,433	-0-	-0-	Trinity <sup>(6)</sup>	5.702
Total . . . . .		<u>\$ 66,597</u>	<u>\$136,897</u>	<u>-0-</u>		
<b>New Veterans G.O. Bonds</b>						
Series BQ/BR <sup>(7)</sup> . . . . .	6/1/99	-0-	80,000	-0-	N.A.	N.A.
Unrestricted G.O. Bond Series						
Recycling Subaccount 2 <sup>(10)</sup> . . . . .	5/4/99	100,000	-0-	-0-	Trinity <sup>(10)</sup>	5.21
Total . . . . .		<u>\$100,000</u>	<u>\$ 80,000</u>	<u>-0-</u>		
<b>Short-Term Veterans G.O. Bonds</b>						
Series BJ <sup>(4)</sup> . . . . .	4/28/99	-0-	271,500	-0-	N.A.	N.A.
Total . . . . .		<u>-0-</u>	<u>\$271,500</u>	<u>-0-</u>		
<b>Total with respect to Veterans G.O. Bonds . . . . .</b>		<u>\$166,597</u>	<u>\$488,397</u>	<u>-0-</u>		
<b>Existing Revenue Bonds</b>						
143 Revenue Bond Series						
Recycling Subaccount . . . . .	11/30/98	-0-	-0-	212,963	Soc Gen <sup>(2)(8)</sup>	5.730
Total . . . . .		<u>-0-</u>	<u>-0-</u>	<u>\$212,963</u>		
<b>New Revenue Bonds</b>						
1999 Series A/B <sup>(9)</sup> . . . . .	3/30/99 and 8/1/99	2,725	-0-	-0-	SMIF	Variable
Total . . . . .		<u>\$ 2,725</u>	<u>-0-</u>	<u>-0-</u>		
<b>Short-Term Revenue Bonds</b>						
1997 Series C <sup>(4)</sup> . . . . .	3/30/99	-0-	-0-	93,000	NatWest <sup>(11)</sup>	4.98
Total . . . . .		<u>-0-</u>	<u>-0-</u>	<u>\$ 93,000</u>		
<b>Total with respect to Revenue Bonds . . . . .</b>		<u>\$ 2,725</u>	<u>-0-</u>	<u>\$305,963</u>		
<b>Total . . . . .</b>		<u>\$169,322</u>	<u>\$488,397</u>	<u>\$305,963</u>		

*Footnotes are on the following page.*

- 
- (1) 000s omitted.
  - (2) On February 1, 1999, Moody's announced that it had placed under review for possible downgrade certain ratings of Societe Generale, including its long-term ratings (senior debts and deposits, currently rated at Aa3 by Moody's) and its bank financial strength rating (currently rated at B by Moody's).
  - (3) Investment agreement maturing December 1, 2000 with Societe Generale.
  - (4) Proceeds will become available only with respect to those bonds on which the interest rate has been adjusted to fixed interest rates to maturity. Prior to 4/28/99, proceeds of the Series BJ Bonds are invested in an investment agreement with Societe Generale, at an investment rate of 5.52%.
  - (5) Investment agreement maturing April 1, 2000 with FGIC Capital Market Services, Inc. ("FCMSI"). The payment obligations of FCMSI under the investment agreement will be guaranteed by General Electric Capital Corporation ("GE Capital").
  - (6) Investment agreement maturing April 1, 2001 with Trinity Plus Funding Company, LLC ("Trinity"). Under certain circumstances, Trinity will have the benefits of a letter of credit from GE Capital and of a revolving liquidity facility under which GE Capital is a lender (there can be additional lenders under the liquidity facility). However, the aggregate of the amounts available under the letter of credit and the liquidity facility may be significantly less than Trinity's obligations under its investment agreements.
  - (7) The 1999 Veterans G.O. Bonds expected to be delivered on or before 4/28/99.
  - (8) Investment agreement maturing December 1, 2001 with Societe Generale.
  - (9) The Offered 1999 Revenue Bonds.
  - (10) Subaccount to be created upon the issuance of the 1999 Series B Bonds. Expected investment agreement maturing December 1, 2001 with Trinity. Under certain circumstances, Trinity will have the benefits of a letter of credit from GE Capital as described in footnote (6).
  - (11) Expected investment agreement maturing December 1, 2001 with National Westminster Bank Plc.

## Cancellations and Delinquencies

Set forth in the table below is a comparative chart of delinquent, cancelled and repossessed Contracts of Purchase and certain comparative information regarding USDVA guaranteed loans during the same period.

	<u>1994<sup>(1)</sup></u>	<u>1995<sup>(1)</sup></u>	<u>1996<sup>(1)</sup></u>	<u>1997<sup>(1)</sup></u>	<u>1998<sup>(1)</sup></u>	<u>1999<sup>(2)</sup></u>
<b>Percentage of Number of Contracts of Purchase</b>						
Delinquent <sup>(3)</sup>						
30-67 days .....	0.99%	1.45%	2.90%	1.65%	0.78%	0.76%
68+ days .....	4.24%	3.12%	2.50%	3.22%	1.99%	2.17%
Cancelled Contracts and Bankruptcies <sup>(4)</sup> .....	0.38%	0.64%	0.82%	0.94%	0.82%	0.71%
Repossessed Contracts .....	0.35%	0.64%	1.07%	0.92%	0.67%	0.58%
<b>USDVA Guaranteed Loans<sup>(5)</sup></b>						
Percentages in U.S.						
Delinquent						
30-60 days .....	4.07%	4.14%	4.59%	4.54%	4.45%	4.71%
60+ days .....	2.25%	2.21%	2.20%	2.21%	2.35%	2.62%
Foreclosures in inventory .....	1.44%	1.26%	1.54%	1.81%	1.77%	1.90%
Percentages in California						
Delinquent						
30-60 days .....	3.42%	4.03%	4.23%	4.30%	4.28%	4.78%
60+ days .....	2.36%	2.53%	2.36%	2.52%	2.61%	2.98%
Foreclosures in inventory .....	2.28%	2.31%	3.18%	3.54%	2.92%	2.98%

(1) As of June 18 for Department's and as of June 30 for USDVA data.

(2) Department information as of November 30, 1998. USDVA information currently is not available and is shown as of September 30, 1998.

(3) Time periods conform to Department's record-keeping system.

(4) Bankruptcies are included in cancelled Contracts statistics and do not exceed in any period more than 10% of total cancellations and bankruptcy category. Federal bankruptcy law precludes repossession action of Contracts of Purchase when veteran is in bankruptcy proceedings until the automatic stay is lifted.

(5) Source: National Delinquency Survey published by the Mortgage Bankers Association of America.

## Veterans G.O. Bonds and Revenue Bonds

The chart below sets forth certain information regarding Veterans G.O. Bonds and Revenue Bonds, including those expected to be redeemed, defeased or retired as a result of the issuance of the Offered 1999 Revenue Bonds and the 1999 Veterans G.O. Bonds.

### Selected Information with Respect to Veterans G.O. Bonds and Revenue Bonds

Series	Bonds Outstanding as of 10/1/98	Bonds Expected to be Outstanding as of 5/4/99	Final Maturity or Mandatory Tender Date of Series	Next Option Call Date	Call Price on Such Date	Maximum Coupon Subject to Optional Call	Bond Subject to Special Redemption
<b>Veterans G.O. Bonds Issued Prior to the Mortgage Subsidy Bond Tax Act of 1980</b>							
QQ .....	\$ 9,600,000	\$ 4,800,000 <sup>(2)</sup>	February 1, 2000	Non-Callable	N.A.	N.A.	No
YY .....	42,600,000	— <sup>(1)</sup>					
ZZ/AB .....	35,500,000	— <sup>(1)</sup>					
AC .....	35,500,000	— <sup>(1)</sup>					
AD .....	49,200,000	42,600,000 <sup>(2)</sup>	April 1, 2005	April 1, 2000	100%	6.800%	No
AE .....	26,240,000	22,720,000 <sup>(1)</sup>	August 1, 2005	August 1, 2000	100%	7.000%	No
AF .....	39,360,000	34,080,000 <sup>(1)</sup>	August 1, 2005	August 1, 2000	100%	7.300%	No
AG .....	49,200,000	49,200,000	October 1, 2005	October 1, 2000	100%	8.250%	No
Sub-total .....	\$ 287,200,000	\$ 153,400,000					
<b>Veterans G.O. Bonds Issued to Refund Bonds Issued Prior to the Mortgage Subsidy Bond Tax Act of 1980</b>							
BM .....	\$ 66,600,000	\$ 66,600,000	December 1, 2025	— <sup>(3)</sup>	— <sup>(3)</sup>	5.450%	Excess Revenues/Unexpended
BN2-4 .....	91,065,000	91,065,000	December 1, 2028	— <sup>(3)</sup>	— <sup>(3)</sup>	5.450%	Excess Revenues/Unexpended
	\$ 157,665,000	\$ 157,665,000					
<b>Veterans G.O. Bonds Issued as Qualified Veterans Mortgage Bonds under the 1954 Code</b>							
AH .....	\$ 56,000,000	\$ 56,000,000	August 1, 2006	August 1, 2001	100%	10.000%	No
AK .....	13,500,000	12,000,000	April 1, 2007	Non-callable	N.A.	N.A.	No
AL .....	44,000,000	38,000,000	April 1, 2007	Non-callable	N.A.	N.A.	No
AM .....	60,000,000	60,000,000	October 1, 2008	Non-callable	N.A.	N.A.	No
AN/AP .....	91,500,000	90,000,000	April 1, 2009	Non-callable	N.A.	N.A.	No
AQ .....	90,000,000	90,000,000	October 1, 2008	Non-callable	N.A.	N.A.	No
AR .....	43,500,000	43,500,000	October 1, 2009	Non-callable	N.A.	N.A.	No
AS .....	44,000,000	44,000,000	October 1, 2009	Non-callable	N.A.	N.A.	No
AT .....	207,485,000	194,155,000	February 1, 2010	Non-callable	N.A.	N.A.	No
AU .....	130,790,000	130,790,000	October 1, 2010	Non-callable	N.A.	N.A.	No
AV .....	89,665,000	89,665,000	October 1, 2010	Non-callable	N.A.	N.A.	No
Sub-total .....	\$ 870,440,000	\$ 848,110,000					
<b>Veterans G.O. Bonds Issued as Qualified Veterans Mortgage Bonds under the 1986 Code</b>							
BC/BF <sup>(4)</sup> .....	\$ 338,745,000	\$ 320,745,000 <sup>(10)</sup>	February 1, 2027	June 1, 1999	101%	6.550%	Allocated Prepayments <sup>(5)</sup>
BG/BH .....	586,355,000	586,355,000	December 1, 2032	— <sup>(6)</sup>	— <sup>(6)</sup>	5.600% <sup>(6)</sup>	Excess Revenues/Unexpended
BJ .....	300,000,000	271,500,000	June 1, 1999 <sup>(7)</sup>	at any time <sup>(7)</sup>	100%	4.125% <sup>(7)</sup>	Unexpended
BK/BL .....	280,615,000	255,615,000 <sup>(10)</sup>	December 1, 2012	— <sup>(6)</sup>	— <sup>(6)</sup>	5.300% <sup>(6)</sup>	Excess Revenues/Unexpended
BP/BN <sup>(3)</sup> .....	14,000,000	14,000,000	December 1, 2026	— <sup>(3)</sup>	— <sup>(3)</sup>	5.500% <sup>(3)</sup>	Excess Revenues/Unexpended
BQ/BR <sup>(8)</sup> .....	—	80,000,000	— <sup>(8)</sup>	— <sup>(8)</sup>	— <sup>(8)</sup>	— <sup>(8)</sup>	— <sup>(8)</sup>
Sub-total .....	\$1,519,715,000	\$1,528,215,000					
TOTAL VETERANS G.O. BONDS .....	\$2,835,020,000	\$2,687,390,000					

<u>Series</u>	<u>Bonds Outstanding as of 10/1/98</u>	<u>Bonds Expected to be Outstanding as of 5/4/99</u>	<u>Final Maturity or Mandatory Tender Date of Series</u>	<u>Next Option Call Date</u>	<u>Call Price on Such Date</u>	<u>Maximum Coupon Subject to Optional Call</u>	<u>Bond Subject to Special Redemption</u>
<b>Revenue Bonds Issued as Qualified Mortgage Bonds under the 1986 Code</b>							
1997 A/B .....	\$ 20,990,000	\$ 20,755,000	December 1, 2028	December 1, 2008	101%	5.500%	Excess Revenues/Unexpended
1997 C .....	100,000,000	100,000,000 <sup>(9)</sup>	December 1, 2001	August 1, 2000	100%	3.65%	Unexpended
1998 A .....	154,065,000	148,380,000	December 1, 2019	December 1, 2008	101%	5.450%	Excess Revenues/Unexpended
Sub-total .....	\$ 275,055,000	\$ 269,135,000					
<b>Revenue Bonds Issued to Refund Bonds Issued Prior to Mortgage Subsidy Bond Tax Act of 1980</b>							
1999 A <sup>(9)</sup> .....	—	\$ 54,170,000 <sup>(9)</sup>	December 1, 2027	June 1, 2004	101%	5.20%	Excess Revenues/Unexpended
1999 B <sup>(9)</sup> .....	—	86,085,000 <sup>(9)</sup>	December 1, 2028	June 1, 2004	101%	5.20%	Excess Revenues/Unexpended
Sub-total .....	—	\$ 140,255,000					
TOTAL REVENUE BONDS .....	\$ 275,055,000	\$ 409,390,000					
TOTAL ALL BONDS ...	\$3,110,075,000	\$3,096,780,000					

- (1) Reduction in an amount reflects those Veterans G.O. Bonds expected to be retired following expected sale and delivery of Offered 1999 Revenue Bonds on or about May 4, 1999.
- (2) Reduction in an amount reflects those Veterans G.O. Bonds expected to be retired following expected sale and delivery of Offered 1999 Revenue Bonds on or about March 30, 1999.
- (3) The Series BM Bonds and Series BN Bonds maturing on and before December 1, 2004 are subject to optional redemption at par on and after June 1, 2000. The remaining Series BM Bonds and Series BN Bonds and all of the Series BP Bonds are subject to optional redemption on and after December 1, 2003, initially at 101% of the principal amount thereof, declining to par on and after December 1, 2004.
- (4) Includes Series BC, Series BD, Series BE and Series BF.
- (5) Subject to redemption at par from a portion of prepayments on all Contracts of Purchase as allocated to Series based on periodically determined ratio of outstanding bonds (including Veterans G.O. Bonds and Revenue Bonds) of Series to all outstanding bonds.
- (6) Except as described in the next sentence, the Series BG Bonds, Series BH Bonds, and Series BL Bonds are subject to optional redemption on and after December 1, 2008, initially at 101% of the principal amount thereof, declining to par on December 1, 2009. The Series BH Bonds maturing on December 1, 2018, December 1, 2024, and December 1, 2032 are subject to optional redemption on and after December 1, 2003 at 102% of the principal amount thereof, declining to 101% of the principal amount thereof on and after December 1, 2004, and declining further to par on December 1, 2005. The Series BK Bonds are not subject to optional redemption.
- (7) The Series BJ Bonds are expected to be remarketed, in part, at new short term rates to mandatory tender dates on or about April 28, 1999.
- (8) Expected offering of 1999 Veterans G.O. Bonds.
- (9) The Offered Revenue Bonds.
- (10) Reduction in an amount reflects those Veterans G.O. Bonds expected to be retired following expected sale and delivery of the 1999 Veterans G.O. Bonds.



### Additional Investments

In addition to the investments described above under "Contracts of Purchase—Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments," the following investments have been made or will be made with respect to moneys in the 1943 Fund and the Bond Reserve Account which secures the Revenue Bonds:

<u>Fund or Account Designation<sup>(1)</sup></u>	<u>Amount</u>	<u>Type of Investment</u>	<u>Investment Provider</u>	<u>Investment Maturity Date</u>	<u>Investment (%)</u>
1997/1998 Bond Reserve Subaccount .....	\$5,251,650	investment agreement	Societe Generale <sup>(3)</sup>	12/1/28	5.75
	\$7,001,992 <sup>(2)</sup>	U.S. Treasury Bond	N.A.	5/15/05	6.50
1999 Bond Reserve Subaccount <sup>(4)</sup> .....	\$9,817,850	investment agreement	Westdeutsche Landesbank Girozentrale	12/1/28	5.38
1997/1998 Revenue Bond Series Revenue Subaccount and 1997/1998 Revenue Bond Series Restricted Recoveries Subaccount .....	variable	investment agreement	Societe Generale <sup>(3)</sup>	12/1/28	5.91
BG, BH, BK, BL G.O. Bond Series Revenue Subaccount and BG, BH, BK, BL G.O. Bonds Series Recycling Subaccount .....	variable <sup>(5)</sup>	investment agreement	Societe Generale <sup>(3)</sup>	12/1/32	5.91
BM, BN G.O. Bond Series Revenue Subaccount .....	variable	investment agreement	Westdeutsche Landesbank Girozentrale	12/1/28	5.38
BM, BN G.O. Bond Series Recycling Subaccount .....	variable <sup>(6)</sup>	investment agreement	Westdeutsche Landesbank Girozentrale	12/1/28	5.38
BP G.O. Bond Series Revenue Subaccount .....	variable	investment agreement	Westdeutsche Landesbank Girozentrale	12/1/28	5.38
BP G.O. Bond Series Recycling Subaccount .....	variable <sup>(6)</sup>	investment agreement	Westdeutsche Landesbank Girozentrale	12/1/28	5.38
1999 A/B Revenue Bond Series Revenue Subaccount and 1999 A/B Revenue Bond Series Recycling Subaccount <sup>(4)</sup> .....	variable <sup>(7)</sup>	investment agreement	Bayerische Landesbank Girozentrale	12/1/28	5.30

(1) Accounts are established in the resolutions authorizing the issuance of Revenue Bonds.

(2) At cost.

(3) On February 1, 1999, Moody's announced that it had placed under review for possible downgrade certain ratings of Societe Generale, including its long-term ratings (senior debts and deposits, currently rated at Aa3 by Moody's) and its bank financial strength rating (currently rated at B by Moody's).

(4) Expected investment with respect to the Offered 1999 Revenue Bonds.

(5) Maximum permitted amount on deposit under investment agreement at any one time is \$250,000,000.

(6) Aggregate maximum permitted amount on deposit under investment agreement for both accounts is \$50,000,000.

(7) Aggregate maximum permitted amount on deposit under investment agreement for both accounts is \$75,000,000.

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**EXHIBIT F**

**PROPOSED FORMS OF OPINIONS OF ATTORNEY GENERAL AND BOND COUNSEL  
TO BE DELIVERED IN CONNECTION WITH THE ISSUANCE OF  
THE OFFERED 1999 REVENUE BONDS**

***PROPOSED FORM OF OPINION WITH RESPECT TO THE 1999 SERIES A BONDS***

**BILL LOCKYER**  
Attorney General  
State of California  
1300 I Street  
Sacramento, California 95814

**HAWKINS, DELAFIELD & WOOD**  
First Interstate World Center  
633 West Fifth Street  
Los Angeles, California 90071

[closing date]

Department of Veterans Affairs  
of the State of California  
1227 "O" Street, Room 200A  
Sacramento, California 95814

Ladies and Gentlemen:

We have acted as Attorney General of the State of California and as bond counsel, respectively, and in such capacities we have examined upon request copies of proceedings taken by the Department of Veterans Affairs of the State of California (the "Department") in connection with the issuance of the Department's Home Purchase Revenue Bonds, 1999 Series A (the "Bonds"), in the aggregate principal amount of \$54,170,000, and the sale of the Bonds to the initial purchasers thereof. The Bonds are issued pursuant to (1) the Veterans' Revenue Debenture Act of 1970, as amended, constituting Chapter 7 of Division 4 of the Military and Veterans Code of the State of California (the "Veterans Act"), (2) the Resolution of Issuance for Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, adopted March 19, 1980 (the "Resolution of Issuance"), (3) the Eighth Supplemental Resolution Providing for Amendments and Supplements to the Resolution No. RB-1, adopted November 24, 1997 (the "Eighth Supplemental Resolution"), (4) the Tenth Supplemental Resolution Providing for Amendments and Supplements to the Resolution No. RB-1, adopted February 24, 1999 (the "Tenth Supplemental Resolution"), and (5) the Eleventh Supplemental Resolution Providing for the Issuance of an Amount Not to Exceed \$242,000,000 Principal Amount of Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, 1999 Series A and 1999 Series B, adopted February 24, 1999 (the "Eleventh Supplemental Resolution"). The Resolution of Issuance, the Eighth Supplemental Resolution, the Tenth Supplemental Resolution and the Eleventh Supplemental Resolution are collectively referred to herein as the "Resolution."

The Bonds are dated, mature on the dates in the principal amounts, bear interest, if any, are subject to mandatory tender, and are payable as provided in the Resolution. The Bonds are subject to redemption prior to maturity in whole or in part as set forth in the Resolution.

The Department expects to issue its Home Purchase Revenue Bonds, 1999 Series B on or about May 4, 1999 (the "1999 Series B Bonds"). The Bonds and the 1999 Series B Bonds are treated as a single issue for certain federal tax purposes under the Internal Revenue Code of 1986, as amended (the "Code"). Applicable Federal tax law establishes certain requirements that must be met subsequent to the respective issuances of the Bonds and the 1999 Series B Bonds in

order that interest on the Bonds not be included in gross income for Federal income tax purposes under the Code. The Department has adopted documents with respect to its program (the "Program Documents") that establish procedures under which, if followed, such requirements can be met. The Department has covenanted in the Resolution to at all times perform all acts and things permitted by law and necessary and desirable in order to assure that interest paid on the Bonds shall not be included in gross income for Federal income tax purposes under the Code. In rendering this opinion, we have relied upon such covenant and have assumed compliance by the Department with and enforcement by the Department of the provisions of the Resolution and the Program Documents.

In connection with the issuance of the Bonds, we have examined (a) a copy of the Resolution, and (b) such other opinions, documents, certificates and letters as we deem relevant and necessary in rendering this opinion.

From such examination, we are of the opinion that:

(i) Pursuant to the Veterans Act, the Department is empowered to issue the Bonds for the purposes specified in the Resolution and to pledge the revenues and amounts in the funds and accounts established by the Resolution.

(ii) The Bonds have been validly authorized, executed and issued in accordance with the laws of the State of California and represent the legally valid and binding special obligations of the Department, enforceable in accordance with their terms and secured in the manner and to the extent set forth in the Resolution and are entitled to the benefit, protection and security of the provisions, covenants and agreements contained therein.

(iii) The Resolution has been duly and lawfully adopted, is a valid resolution of the Department and is binding upon the Department in accordance with its terms.

(iv) The Resolution creates a valid pledge to secure, on an equal and pro rata basis, the payment, subject to lawful appropriation, of the principal of and interest on the Bonds of (1) an undivided interest in the assets of the Veterans' Farm and Home Building Fund of 1943 (the "1943 Fund"), except proceeds of State veterans general obligation bonds and amounts in the Rebate Account established under the Resolution, which undivided interest is secondary and subordinate to any interest or right of the people of the State of California and the holders of general obligation bonds of the Department in the 1943 Fund, created in accordance with any general obligation veterans bond act, (2) any amounts held in the Bond Reserve Account established pursuant to the Resolution, and (3) any amounts held in the Loan Loss Account established pursuant to the Resolution, which pledge is subject only to the provisions of the Resolution permitting the application of such assets and amounts for or to the purposes and on the terms and conditions set forth in the Resolution.

(v) Under existing statutes and court decisions, (a) interest on the Bonds is not included in gross income for Federal income tax purposes pursuant to Section 103 of the Code, and (b) interest on the Bonds is not treated as a preference item for purposes of calculating the federal alternative minimum tax with respect to individuals and corporations; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations. No opinion as to exclusion from gross income of interest on any of the Bonds is expressed subsequent to any date on which action is taken pursuant to the Resolution for which action the Resolution requires a legal opinion to the effect that taking such action will not adversely affect such exclusion, should the undersigned not deliver an opinion as of such date to such effect.

(vi) Interest on the Bonds is exempt from State personal income taxation under present State law.

In rendering this opinion, we are advising you that the enforceability of the Bonds and the Resolution may be limited by bankruptcy, moratorium, insolvency, or other laws affecting creditors' rights or remedies and is subject to general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

We have examined an executed 1999 Series A Bond and, in our opinion, the form of said Bond and its execution are regular and proper.

Very truly yours,

***PROPOSED FORM OF OPINION WITH RESPECT TO THE 1999 SERIES B BONDS***

**BILL LOCKYER**

Attorney General

State of California

1300 I Street

Sacramento, California 95814

**HAWKINS, DELAFIELD & WOOD**

First Interstate World Center

633 West Fifth Street

Los Angeles, California 90071

[closing date]

Department of Veterans Affairs  
of the State of California  
1227 "O" Street, Room 200A  
Sacramento, California 95814

Ladies and Gentlemen:

We have acted as Attorney General of the State of California and as bond counsel, respectively, and in such capacities we have examined upon request copies of proceedings taken by the Department of Veterans Affairs of the State of California (the "Department") in connection with the issuance of the Department's Home Purchase Revenue Bonds, 1999 Series B (the "Bonds"), in the aggregate principal amount of \$86,085,000, and the sale of the Bonds to the initial purchasers thereof. The Bonds are issued pursuant to (1) the Veterans' Revenue Debenture Act of 1970, as amended, constituting Chapter 7 of Division 4 of the Military and Veterans Code of the State of California (the "Veterans Act"), (2) the Resolution of Issuance for Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, adopted March 19, 1980 (the "Resolution of Issuance"), (3) the Eighth Supplemental Resolution Providing for Amendments and Supplements to the Resolution No. RB-1, adopted November 24, 1997 (the "Eighth Supplemental Resolution"), (4) the Tenth Supplemental Resolution Providing for Amendments and Supplements to the Resolution No. RB-1, adopted February 24, 1999 (the "Tenth Supplemental Resolution"), and (5) the Eleventh Supplemental Resolution Providing for the Issuance of an Amount Not to Exceed \$242,000,000 Principal Amount of Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, 1999 Series A and 1999 Series B, adopted February 24, 1999 (the "Eleventh Supplemental Resolution"). The Resolution of Issuance, the Eighth Supplemental Resolution, the Tenth Supplemental Resolution, and the Eleventh Supplemental Resolution are collectively referred to herein as the "Resolution."

The Bonds are dated, mature on the dates in the principal amounts, bear interest, if any, are subject to mandatory tender, and are payable as provided in the Resolution. The Bonds are subject to redemption prior to maturity in whole or in part as set forth in the Resolution.

The Department issued its Home Purchase Revenue Bonds, 1999 Series A on March 30, 1999 (the "Series A Bonds"). The Bonds and the Series A Bonds are treated as a single issue for certain federal tax purposes under the Internal Revenue Code of 1986, as amended (the "Code"). Applicable Federal tax law establishes certain requirements that must be met subsequent to the respective issuances of the Bonds and the Series A Bonds in order that interest on the Bonds not be included in gross income for Federal income tax purposes under the Code. The Department has adopted documents with respect to its program (the "Program Documents") that establish procedures under which, if followed, such requirements can be met. The Department has covenanted in the Resolution to at all times perform all acts and things permitted by law and necessary and

desirable in order to assure that interest paid on the Bonds shall not be included in gross income for Federal income tax purposes under the Code. In rendering this opinion, we have relied upon such covenant and have assumed compliance by the Department with and enforcement by the Department of the provisions of the Resolution and the Program Documents.

In connection with the issuance of the Bonds, we have examined (a) a copy of the Resolution, and (b) such other opinions, documents, certificates and letters as we deem relevant and necessary in rendering this opinion.

From such examination, we are of the opinion that:

(i) Pursuant to the Veterans Act, the Department is empowered to issue the Bonds for the purposes specified in the Resolution and to pledge the revenues and amounts in the funds and accounts established by the Resolution.

(ii) The Bonds have been validly authorized, executed and issued in accordance with the laws of the State of California and represent the legally valid and binding special obligations of the Department, enforceable in accordance with their terms and secured in the manner and to the extent set forth in the Resolution and are entitled to the benefit, protection and security of the provisions, covenants and agreements contained therein.

(iii) The Resolution has been duly and lawfully adopted, is a valid resolution of the Department and is binding upon the Department in accordance with its terms.

(iv) The Resolution creates a valid pledge to secure, on an equal and pro rata basis, the payment, subject to lawful appropriation, of the principal of and interest on the Bonds of (1) an undivided interest in the assets of the Veterans' Farm and Home Building Fund of 1943 (the "1943 Fund"), except proceeds of State veterans general obligation bonds and amounts in the Rebate Account established under the Resolution, which undivided interest is secondary and subordinate to any interest or right of the people of the State of California and the holders of general obligation bonds of the Department in the 1943 Fund, created in accordance with any general obligation veterans bond act, (2) any amounts held in the Bond Reserve Account established pursuant to the Resolution, and (3) any amounts held in the Loan Loss Account established pursuant to the Resolution, which pledge is subject only to the provisions of the Resolution permitting the application of such assets and amounts for or to the purposes and on the terms and conditions set forth in the Resolution.

(v) Under existing statutes and court decisions, (a) interest on the Bonds is not included in gross income for Federal income tax purposes pursuant to Section 103 of the Code, and (b) interest on the Bonds is not treated as a preference item for purposes of calculating the Federal alternative minimum tax with respect to individuals and corporations; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations. No opinion as to exclusion from gross income of interest on any of the Bonds is expressed subsequent to any date on which action is taken pursuant to the Resolution for which action the Resolution requires a legal opinion to the effect that taking such action will not adversely affect such exclusion, should the undersigned not deliver an opinion as of such date to such effect.

(vi) Interest on the Bonds is exempt from State personal income taxation under present State law.

In rendering this opinion, we are advising you that the enforceability of the Bonds and the Resolution may be limited by bankruptcy, moratorium, insolvency, or other laws affecting creditors' rights or remedies and is subject to general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

We have examined an executed Bond and, in our opinion, the form of said Bond and its execution are regular and proper.

Very truly yours,



**EXHIBIT G**

**OPINION OF ATTORNEY GENERAL AND BOND COUNSEL  
DELIVERED IN CONNECTION WITH THE ISSUANCE  
OF THE 1997 SERIES C BONDS**

**DANIEL E. LUNGREN**  
Attorney General  
State of California  
1300 I Street  
Sacramento, California 95814

**HAWKINS, DELAFIELD & WOOD**  
67 Wall Street  
New York, New York 10005

December 29, 1997

Department of Veterans Affairs  
of the State of California  
1227 "O" Street, Room 200A  
Sacramento, California 95814

Ladies and Gentlemen:

We have acted as Attorney General of the State of California and as bond counsel, respectively, and in such capacities we have examined upon request copies of proceedings taken by the Department of Veterans Affairs of the State of California (the "Department") in connection with the issuance of the Department's Home Purchase Revenue Bonds, 1997 Series A, 1997 Series B, and 1997 Series C (respectively, the "1997 Series A Bonds," the "1997 Series B Bonds," and the "1997 Series C Bonds," and, collectively, the "Bonds"), in the aggregate principal amount of \$120,990,000, and the sale of the Bonds to the initial purchasers thereof. The Bonds are issued pursuant to (1) the Veterans' Revenue Debenture Act of 1970, as amended, constituting Chapter 7 of Division 4 of the Military and Veterans Code of the State of California (the "Veterans Act"), (2) the Resolution of Issuance for Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, adopted March 19, 1980 (the "Resolution of Issuance"), (3) the Eighth Supplemental Resolution Providing for Amendments and Supplements to the Resolution No. RB-1, adopted November 24, 1997 (the "Eighth Supplemental Resolution"), and (4) the Ninth Supplemental Resolution Providing for the Issuance of an Amount Not to Exceed \$294,430,000 Principal Amount of Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, 1997 Series A, 1997 Series B, 1997 Series C and 1998 Series A, adopted November 24, 1997 and amended December 22, 1997 (the "Ninth Supplemental Resolution"). The Resolution of Issuance, the Eighth Supplemental Resolution and the Ninth Supplemental Resolution, are collectively referred to herein as the "Resolution."

The Bonds are dated, mature on the dates in the principal amounts, bear interest, if any, are subject to mandatory tender, and are payable as provided in the Resolution. The Bonds are subject to redemption prior to maturity in whole or in part as set forth in the Resolution.

The Department expects to issue its Home Purchase Revenue Bonds, 1998 Series A on or about May 5, 1998 (the "1998 Series A Bonds"). The State of California (the "State") will issue Veterans General Obligation Bonds, Series BG, BH, BJ, BK and BL (the "Veterans G.O. Bonds") on or about December 29, 1997 and January 5, 1998. The Bonds, the 1998 Series A Bonds and the Veterans G.O. Bonds are treated as a single issue for certain federal tax purposes under the

Internal Revenue Code of 1986, as amended (the "Code"). Applicable Federal tax law establishes certain requirements that must be met subsequent to the respective issuances of the Bonds, the 1998 Series A Bonds, and Veterans G.O. Bonds in order that interest on the Bonds not be included in gross income for Federal income tax purposes under the Code. The Department has adopted documents with respect to its program (the "Program Documents") that establish procedures under which, if followed, such requirements can be met. The Department has covenanted in the Resolution to at all time perform all acts and things permitted by law and necessary and desirable in order to assure that interest paid on the Bonds shall not be included in gross income for Federal income tax purposes under the Code. In rendering this opinion, we have relied upon such covenant and have assumed compliance by the Department with and enforcement by the Department of the provisions of the Resolution and the Program Documents. We have also relied upon the approving opinion of Orrick, Herrington & Sutcliffe LLP dated this date with respect to the Veterans G.O. Bonds as to the validity and legality of the Veterans G.O. Bonds and as to exclusion of the interest thereon from gross income of the owners thereof for federal income tax purposes.

In connection with the issuance of the Bonds, we have examined (a) a copy of the Resolution, and (b) such other opinions, documents, certificates and letters as we deem relevant and necessary in rendering this opinion.

From such examination, we are of the opinion that:

(i) Pursuant to the Veterans Act, the Department is empowered to issue the Bonds for the purposes specified in the Resolution and to pledge the revenues and amounts in the funds and accounts established by the Resolution.

(ii) The Bonds have been validly authorized, executed and issued in accordance with the laws of the State of California and represent the legally valid and binding special obligations of the Department, enforceable in accordance with their terms and secured in the manner and to the extent set forth in the Resolution and are entitled to the benefit, protection and security of the provisions, covenants and agreements contained therein.

(iii) The Resolution has been duly and lawfully adopted, is a valid resolution of the Department and is binding upon the Department in accordance with its terms.

(iv) The Resolution creates a valid pledge to secure, on an equal and pro rata basis, the payment of the principal of and interest on the Bonds of (1) an undivided interest in the assets of the Veterans' Farm and Home Building Fund of 1943 (the "1943 Fund"), except proceeds of State veterans general obligation bonds (including Veterans G.O. Bonds) and amounts in the Rebate Account established under the Resolution, which undivided interest is secondary and subordinate to any interest or right of the people of the State of California and the holders of general obligation bonds of the Department in the 1943 Fund, created in accordance with any general obligation veterans bond act, (2) any amounts held in the Bond Reserve Account established pursuant to the Resolution, and (3) any amounts held in the Loan Loss Account established pursuant to Resolution, which pledge is subject only to the provisions of the Resolution permitting the application of such assets and amounts for or to the purposes and on the terms and conditions set forth in the Resolution.

(v) Under existing statutes and court decisions, (a) interest on the Bonds is not included in gross income for Federal income tax purposes pursuant to Section 103 of the Code, (b) the interest on the 1997 Series A Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Code with respect to individuals and corporations; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax

imposed on such corporations; and (c) interest on the 1997 Series B Bonds and 1997 Series C Bonds is treated as a preference item for purposes of calculating the Federal alternative minimum tax with respect to individuals and corporations. No opinion as to exclusion from gross income of interest on any of the Bonds is expressed subsequent to any date on which action is taken pursuant to the Resolution for which action the Resolution requires a legal opinion to the effect that taking such action will not adversely affect such exclusion, should the undersigned not deliver an opinion as of such date to such effect.

(vi) Interest on the Bonds is exempt from State personal income taxation under present State law.

In rendering this opinion, we are advising you that the enforceability of the Bonds and the Resolution may be limited by bankruptcy, moratorium, insolvency, or other laws affecting creditors' rights or remedies and is subject to general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

We have examined an executed 1997 Series A Bond, 1997 Series B Bond and 1997 Series C Bond and, in our opinion, the forms of said Bonds and their execution are regular and proper.

DANIEL E. LUNGREN,  
ATTORNEY GENERAL

Very truly yours,

By /s/ Carol Hunter  
Deputy Attorney General

/s/ Hawkins, Delafield & Wood

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